

## PREFATORY NOTE

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Meeting of the Federal Open Market Committee

November 14-15, 1983

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday afternoon, November 14, 1983, and continuing on Tuesday, November 15, 1983, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman  
Mr. Solomon, Vice Chairman  
Mr. Gramley  
Mr. Guffey  
Mr. Keehn  
Mr. Martin  
Mr. Morris  
Mr. Partee  
Mr. Rice  
Mr. Roberts  
Mrs. Teeters  
Mr. Wallich

Messrs. Boehne, Corrigan, and Mrs. Horn, Alternate  
Members of the Federal Open Market Committee

Messrs. Balles and Black, Presidents of the Federal Reserve  
Banks of San Francisco and Richmond, respectively

Mr. Axilrod, Staff Director and Secretary  
Mr. Bernard, Assistant Secretary  
Mrs. Steele, Deputy Assistant Secretary  
Mr. Bradfield, General Counsel  
Mr. Kichline, Economist  
Mr. Truman, Economist (International)

Messrs. Balbach, T. Davis, Eisenmenger, Prell,  
Scheld, and Zeisel, Associate Economists

Mr. Cross, Manager for Foreign Operations,  
System Open Market Account  
Mr. Sternlight, Manager for Domestic Operations,  
System Open Market Account

Mr. Frost, Staff Director, Office of Staff Director  
for Management, Board of Governors  
Mr. Coyne, Assistant to the Board of Governors  
Mr. Roberts, Assistant to the Chairman, Board of Governors  
Mr. Kohn, Deputy Staff Director, Office of Staff  
Director for Monetary and Financial Policy,  
Board of Governors  
Mr. Lindsey, Associate Director, Division of Research  
and Statistics, Board of Governors  
Mr. Henderson, Deputy Associate Director, Division of  
International Finance, Board of Governors  
Mrs. Low, Open Market Secretariat Assistant,  
Board of Governors

Messrs. Forrestal and Wallace, First Vice Presidents,  
Federal Reserve Banks of Atlanta and Dallas

Mr. Fousek, Executive Vice President, Federal Reserve  
Bank of New York

Messrs. Burns, J. Davis, Koch, Mullineaux, Parthemos, and  
Stern, Senior Vice Presidents, Federal Reserve Banks  
of Dallas, Cleveland, Atlanta, Philadelphia, Richmond,  
and Minneapolis, respectively

Mr. Bisignano, Vice President, Federal Reserve Bank of  
San Francisco

Ms. Meulendyke, Manager, Securities Department, Federal  
Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting of  
November 14-15, 1983

November 14, 1983--Afternoon Session

[Secretary's note: The Committee convened prior to the regular FOMC meeting to hear a presentation on inflation by Mr. Slifman, Ms. Zickler, and Mr. Stockton of the Board's staff. Although the presentation and subsequent discussion were not part of the official meeting, the text of the Committee's discussion is shown below and the staff statements are included in the Appendix.]

CHAIRMAN VOLCKER. That was a real performance. We have to [decide on] the long-run [monetary] targets for next year soon and present some [economic] projections. There have been some proposals that we present projections through 1988, which happens to coincide with [the period covered in] the last table [distributed for this presentation]. We're not yet obligated to do that; I don't know whether we will be by the time we get around to presenting our long-range projections. We're going to have to decide how we will collectively look at this situation. The staff has a pretty sharp decline in M2 in 1984 to get on this track [toward price stability]. What is it going to be this year?

MR. STOCKTON. M2 in this price stability case is 6 percent and that's down from our projection for 1984 of an 8 percent increase at an annual rate.

MR. PARTEE. Did I understand you to say that if productivity growth is 1 percent higher--that is, 2 percent rather than 1 percent--that the unemployment rate associated with this long-term projection would be about a point lower?

MR. STOCKTON. That's correct. That's because if we assume a 2 percent productivity growth rate, the unemployment rate could fall to 8.1 percent by the end of 1984 and then would stay at about a 7-3/4 percent rate throughout the last four years of the price stability scenario.

MR. PARTEE. Would that mean that total output would be quite a bit higher?

MR. STOCKTON. Yes. That's correct.

MR. PARTEE. Because you have lower unemployment and more output per worker?

MR. STOCKTON. That's correct.

MR. PARTEE. I see.

MR. GRAMLEY. I'd like to ask about the increase in the GNP deflator in 1985. If you take 6-1/2 percent as the natural rate [of unemployment] and we're 2 percentage points above that in both '84 and '85, that should get us, according to your formula, about a 1-1/2 percentage point reduction in inflation per year. You offset that with a drop in the average unemployment rate from 9-1/2 to 8-1/2 between '83 and '84; that should add about a quarter of a percentage

point to the inflation rate. So, on balance, one would think that in '85 we ought to come up with about a 1 to 1-1/4 percentage point lower inflation rate than in '84. But you have it going up. Can you [explain]?

MR. STOCKTON. Yes. The difference is that the exchange rate behaves quite differently. In the price stability case we still have some depreciation of the exchange rate coming and that accounts for the difference.

MR. GRAMLEY. Thank you.

MR. PARTEE. You've taken a fairly restrictive definition of price stability. How sensitive is this last table to that? If you said price stability was 1-1/2 percent or something like that instead of essentially [zero]--

CHAIRMAN VOLCKER. We see how tolerant you are!

MR. PARTEE. In that case you should get [price stability] by 1987.

MR. STOCKTON. Well, there are a couple of things to keep in mind about this price stability [scenario] that we're presenting. The first thing is that in the next two years we think we're facing a couple of hurdles that are going to make it difficult to reach price stability: We have a food price shock that is going to be showing up in 1984 and we have a substantial increase in the social security tax.

CHAIRMAN VOLCKER. How big is that?

MR. STOCKTON. That accounts for about 0.4 percent on compensation over the four quarters of 1984. So, that's almost a half point added back onto compensation. We have some depreciation of the dollar in any of the cases that we are examining and we have some momentum of the recovery moving into 1984. So, we spend the first two years in almost any of these cases just keeping the lid on the special factors that we think are tending to boost inflation in '84 and '85. Even in this case that we're presenting we achieve all the price deceleration really in the last three years. So, we get the deceleration occurring in three years but we have to spend the first two years--the next two years--holding down those things that we think are apt to boost inflation. In either case the costs, obviously, are less the higher you make your target rate of inflation by the end of the period. But it does require fairly low rates of growth, particularly in the next two years.

MR. CORRIGAN. If by the end of the period we're shooting for, say, 1-1/2 percent, would that loosely translate into saying that we could afford 1 percent per year more real growth? Or, what's the order of magnitude?

SPEAKER(?). We have not done that exercise specifically but I would guess that it would just be a marginally lower unemployment path on average compared to the one here.

CHAIRMAN VOLCKER. Might as well go for broke--go for zero. Mr. Morris.

MR. MORRIS. I have an intuitive feeling that your 1 percent productivity assumption is too pessimistic just because I see so many structural changes that were made in the last three years in terms of reducing staff overhead and in terms of changes in work rules. When we went through the 1970s with a lower rate of productivity growth than we could explain on the basis of the ordinary analytical factors, we got a big negative residual. It seems to me that maybe we will start to see some bounceback; maybe we'll start getting a positive residual. What was the basis for your 1 percent productivity assumption, which I think is 1 percentage point too low?

MS. ZICKLER. At this point in the business cycle we're seeing increases that are largely cyclical in nature. We try as best we can to look through these increases and see what underlying trend that type of behavior would be consistent with. And that's basically how we came up with it. Now, you're right, that during the last recession we saw a lot of shedding of labor, a lot of changes that kept productivity growing--even last year during a period when normally it would decline. So, to some extent, these developments that you talk about could be once-and-for-all changes in the productivity level that wouldn't become embodied in a continued improvement in the growth rate. But to the extent that business is making an attempt to invest in new technology and really change on an ongoing basis some of those undefined things--things that we couldn't define during the '70s very well--then, yes, we could be too pessimistic. I think the coming year will be the critical year for evaluating where we are on this productivity path because generally what shows up in the second year of recovery is a sharp deceleration toward a trend rate of growth. If we keep getting information that tells us that the productivity is doing better than 1 percent, that will firm up the view that perhaps the trend is changing and could be closer to 2 percent or whatever.

MR. MARTIN. You didn't mention a more experienced labor force and you didn't mention the impact of these high unemployment rates you project. Do you discount those factors in getting back to the 1.1 percent trend?

MS. ZICKLER. Well, certainly, some reversal of the problem of having inexperienced workers contributed to moving [up] 1/2 percentage point to 1.1 percent. Looking ahead, yes, the demographics could help us out a bit. There has been an ongoing trend. For example, women who entered the labor force in the '60s or '70s now have career attachments to jobs or are staying in the labor force all year and are likely more productive than the new entrants to the labor force. That could help us out; that sort of change occurs very slowly and gradually over time.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I would like to second what Frank said about productivity. There have been a number of changes in the industrial structure and demographics and I think your assumption probably is on the pessimistic side. The point that I want to make is that this baseline case is really a gradualist approach to price stability and I think that's the right way to do it for this kind of analysis. But more realistically we would likely have a recession, say, in 1986 or 1987. I wonder how sensitive this model is to having a third

recession in a period of 6 or 7 years. We have seen lots of forecasts that are always based on a gradualist approach--that we're going to bring inflation down gradually. In reality, if you look back at the history of inflation, inflation really only comes down through recessions. The last time we really knocked inflation in the head was in the 1950s when we had three recessions over about an 8-year period going into the early 60s. So, my question is: What does a recession do in terms of bringing down inflation and in terms of these real variables?

MR. STOCKTON. Well, I think a recession obviously gets the inflation rate down that much faster. And you're right that it's very difficult with models to project business cycles. The earlier that you have the reduction in output the more immediate effect you have on lowering inflation. Then, that lowers inflation expectations through all subsequent periods so that a sharp contraction of output could lead to a substantial reduction in inflation and that would bring down inflation expectations just as it has in the past two years. In essence, the costs have to be paid in any of those cases [through] recession or slow growth.

MR. KICHLINE. Well, it's also the case that where we have '85 and '86 based on a little over 1 percent real growth, the economy is really rather delicately balanced between small and no growth or declining output. If you shorten the time horizon, the model is quite willing to cycle into recession. It's not difficult to get the model to fall into the negative side for real output.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. My question pertains to Chart 18 on the baseline case. I want to preface that by saying that the reason I was so impressed with this presentation is that it's a very useful device for reminding us that an interaction goes on between the monetary side and the real side of the economy and getting these outcomes for almost all the variables we're looking at. With respect to the particular baseline case, in light of the fact that some of us here--I at least--think that the velocity of M1 is in the process now, or soon will be, of returning to a more normal historical pattern, I was wondering if you've done any experimenting with what growth in M1, or indeed other monetary measures such as growth of total reserves, for example, might be consistent with the outcome that you have in unemployment, inflation, and real GNP?

MR. STOCKTON. Well, we looked at the path of M1 that would be capable of generating our price stability scenario, and generally the M1 path that goes along with the baseline case would be around 5 percent next year and would stay at about 5 percent the following year and then drop off to about 2-1/4 percent by 1988.

MR. PARTEE. Gradually?

MR. STOCKTON. Gradually, yes. It's not in a straight line, like putting a ruler down to a piece of paper; it is gradually.

MR. PARTEE. Is it something like 5,5,4,3, and 2 percent?

MR. STOCKTON. [5.5, 5, 3.2, 3 and 2.2] or something like that.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. What does this model assume about real growth in the rest of the world and how sensitive is the conclusion to changes in the assumptions on how the rest of the world is growing?

MR. STOCKTON. I think this model assumes about 2-1/2 percent.

MR. TRUMAN. It's 2-1/2 percent on average and it's a little higher than that in the rest of the world.

VICE CHAIRMAN SOLOMON. Steadily through the 5-year period?

MR. TRUMAN. Right. It is likely reduced by about 0.3 throughout the period as a result of the slower growth in the United States. So, it's a little under 3 percent on the baseline projection, which is basically the staff forecast, and it's a little closer to 2.5 or 2.6 percent after you take account of the impact of the United States on the rest of the world.

VICE CHAIRMAN SOLOMON. That's aside from any influence on the exchange rate. I assume that, say, a 1 point gain in the economic growth in the rest of the world doesn't have much impact on this?

MR. TRUMAN. In terms of the aggregate demand impact, you mean? Well, it would have an impact just like any other demand shift. It would give you a higher level of aggregate demand and in that sense it would put you on a different point on the given--

MR. KICHLIN. But it is a very small effect.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. I just wanted to observe that I have a gut reaction that this real GNP projection is perhaps understated, especially for 1984. But I really wanted to ask a question about the deficit reduction. What kind of assumption are you making for deficit reductions in 1985?

MR. STOCKTON. In the baseline price stability scenario we assume that starting in 1985 equal cuts are made in both taxes and government expenditures, accumulating to \$15 billion on taxes and \$15 billion on expenditures. So, we get \$30 billion the first year, \$60 billion the next year, \$90 billion the following year, and \$120 billion the following year.

CHAIRMAN VOLCKER. It is remarkable that you can give a presentation about inflation and never mention the deficit, and there are a hundred eighty million people out there who think there's some relationship.

MR. RICE. It's in there.



MR. KICHLINE. We didn't focus on that, but it's certainly mentioned.

MR. RICE. That was part of the question I wanted to ask. Is there a feasible monetary policy that is consistent with no progress in reducing the deficit?

MR. STOCKTON. Yes. There certainly is. If it required--

MR. CORRIGAN. You don't want to hear about it.

MR. RICE. Is there a feasible one, a doable one?

MR. STOCKTON. Yes. In fact if no fiscal action is taken, it makes it a bit easier to achieve price stability. Now, the reason for that is that cutting the deficit leads to exchange rate effects through the effect on interest rates. As smaller deficits lead to lower interest rates that has more of an effect on the depreciating dollar, which leads to higher inflation, which you have to offset through less output. So, in fact, the unemployment path needed to achieve price stability, if we assume no fiscal action, would be about 0.2 of a percentage point a year lower than what we--

VICE CHAIRMAN SOLOMON. I don't agree with that, because at some point as the current account deficit gets larger and larger and larger, with huge leaps, we'll see higher interest rates. It's not going to prevent some change--some depreciation of the dollar.

MR. TRUMAN. That's precisely correct, I think. Let me just make two points to President Solomon. One is that to the extent that we have built into the baseline projection some depreciation of the dollar before price stability, essentially, I would view it as part of the process by which we got the dollar very strong to build up the big current account deficit. And in fact we don't have much more built into there than is necessary to keep the current account deficit in the current range. So, therefore, it is possible that it could go further, as Mr. Stockton mentioned when he talked about other exogenous factors--exogenous being outside what we currently predicted--being part of the process. But in some sense that is part of paying the price for the good luck on the dollar or the appreciation of the dollar that we had gotten earlier which had accelerated the short-run process of the disinflation. But once it reverses itself, the lag comes through the system and we will get much more. I would regard this projection as in some sense neutral or agnostic to the extent that it doesn't involve a very big further buildup in the current account. That's true of the baseline and of the projection. Similarly, it doesn't involve so much correction of the value of the dollar; it has as given a relatively moderate growth in the rest of the world such that you get a big improvement in the current account over a period. And in that sense I would say that it's somewhat agnostic in the way it takes--

VICE CHAIRMAN SOLOMON. Let me ask a question of you. When you answered Governor Rice that it would be easier to achieve price stability if we didn't get rid of the budget deficit because of the higher interest rate effect and the higher dollar, are you also assuming a major recession?

MR. STOCKTON. No. The output path there is associated with the one here. It would be basically the same; there's no difference. It's fairly uniform, adding output along those cases that were given.

CHAIRMAN VOLCKER. If I understand you correctly, your assumption on reducing the deficit is that it's bad for inflation?

MR. STOCKTON. That's correct.

MR. KICHLIN. I think we've been very cautious in presenting the issues with respect to inflation expectations, and that's where one presumably has the channel of influence in terms of deficit actions feeding back on inflation expectations. The model simply doesn't capture that. I think Dave has stated that. So, it's in the area of expectations that this model and most models are very weak and that offers something very positive in terms of potential outcome.

CHAIRMAN VOLCKER. It's agnostic on the point that Mr. Solomon is raising as to whether you can have those deficits and have this nice smooth path?

MR. TRUMAN. The particular point is that by achieving a better outcome in 1988 [unintelligible] defined this way to the extent that a different fiscal/monetary [policy] mix over this period gives you higher interest rates, a higher dollar, or a larger current account deficit. So, likewise, it might be if you look beyond 1988 that you would go backwards and have a correction of that process. You would have to work harder just as we are now in terms of a correction if you felt that that kind of current account deficit would not be sustainable for an extended period of time. So, you would have to pay a price later for that.

CHAIRMAN VOLCKER. How much does the level of interest rates itself affect your inflation forecast?

MR. STOCKTON. Well, the level of interest rates plays a small role through cost of capital effects, capital being about 35 percent. But we don't think that's a major effect in short-run price determination.

CHAIRMAN VOLCKER. There's no cost push from high interest rates?

MR. STOCKTON. There's a small cost push from higher interest rates. That's true of our general outlook.

CHAIRMAN VOLCKER. When you say cost of capital, do you mean in terms of cost or in terms of affecting the amount of investment?

MR. STOCKTON. I mean in terms of cost rather than affecting the amount of investment.

MS. TEETERS. What level of interest rates and changes, then, are required to get to the particular path of real GNP?

MR. STOCKTON. The federal funds rate is about 10-3/4 percent in this path for 1984 and drifts down to about 9 percent by 1988.

MS. TEETERS. So the implication is rising interest rates in the short term in order to produce a decreased rate of real growth and price stability.

MR. STOCKTON. That's correct.

CHAIRMAN VOLCKER. You still have 9 percent interest rates with a 1 percent or 3/4 percent rise in prices?

MR. STOCKTON. That's correct.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. This cost of capital of over 30 percent: Does that include depreciation?

MR. STOCKTON. Yes.

MR. WALLICH. Can you tell me a little about the period over which the data in the model reach? My impression is that the model derives its data mostly from a period in which nobody believed that inflation could be reduced to .7 percent, and so it naturally has built in a very strong resistance to that. Now, if we could have a credible policy--if it were believed that your alternative assumption, the last one [listed], is possible and will be done--wouldn't that invalidate many of the assumptions underlying the past data?

MR. STOCKTON. Well, it would certainly change. I hope we made clear that our alternative assumption [of a "credible" disinflation policy]--the last one we've listed under price stability --is clearly a possibility and would alter the cost of achieving price stability. Now, the past couple of years, this credibility issue has been very difficult. I think many economists went out and said: We've never had observations with unemployment that was this high and that has stayed this high so long. And when they reestimated their models they found it looked as if prices were more sensitive to higher rates of unemployment than they previously had thought. But it's not clear. We're not able to distinguish the hypothesis that prices are more sensitive to high rates of unemployment from the hypothesis that perhaps there was a credibility effect which was bringing inflation down faster than might have been thought back in 1980.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. We went through a similar exercise using the [MPS] model. But the difference from what the staff has done in the baseline case is that we used M1 as the money growth rate. We started with 6 percent for 1984 and dropped it 1 point per year for the next 3 years, using 5 percent for 1985, 4 percent for 1986, and 3 percent for 1987 and 1988. That does have some measurable effect on output in the sense that it's just marginally higher in 1984 but is roughly a percentage point higher in both 1985 and 1986. And it brings the inflation rate down to 1 percent at the end of the five-year period. So, what we did was to use M1, dropping it 1 percent a year for the next three years and then holding it stable at 3 percent. And that does give a bit better inflation picture, bringing inflation down in the years 1985 and 1986 a bit faster than is shown in the staff

projection, as well as about a percentage point greater [GNP] growth in 1985 and 1986; it comes out to about the same in 1987 and 1988.

CHAIRMAN VOLCKER. Let me just explore this for a moment. I take it the staff does not agree that that is possible, [barring] some revolution of expectations?

MR. STOCKTON. Well, I'm not certain from the context of the model that--

CHAIRMAN VOLCKER. Well, I don't know about his exact M1 figure but, if I understood Mr. Guffey correctly, he has a model that gives us faster growth and faster deceleration of inflation at the same time.

MR. GUFFEY. That's right. Faster growth in '85 and '86 and faster deceleration in the inflation rate in '86 and '87.

MR. STOCKTON. There are a number of other factors--

MR. KICHLIN. One issue is the growth of productivity. We have extrapolated--

CHAIRMAN VOLCKER. I know one can make other assumptions as to the growth of productivity and all the rest. I don't think I said anything very startling. Unless you make some other assumptions of that sort, you can't come up with that kind of answer. You have to find the answer in productivity or expectations--

MR. STOCKTON. I think that's correct, yes.

MR. GUFFEY. I think we're using the same model.

MR. KICHLIN. Yes, we are.

CHAIRMAN VOLCKER. Well, we'll ask Mr. Guffey how he comes up with a different answer. Did you put in more productivity or different expectations or what?

MR. GUFFEY. I'll have to turn to my staff.

VICE CHAIRMAN SOLOMON. Maybe they have the dollar rising 10 percent a year.

MR. GUFFEY. I think about 14 percent is close. It may be the 18 percent that the staff is looking at.

MR. SLIFMAN. I was cheating and looking over your shoulder and I see that the terminal unemployment rate is 8-1/2 percent in your simulations and the terminal unemployment rate in ours is 8.7 percent, so I really don't think there is that much difference between the basic thrust of the results that your staff has gotten.

MR. GUFFEY. However, I think there is a difference in the unemployment rate because it drops in 1985 to 8.2 percent as opposed to your 8.6 percent and is 8.3 percent for 1986 as opposed to 8.4 percent. And then it comes back to about your level in both 1987 and 1988.

MR. SLIFMAN. I couldn't read all those numbers!

CHAIRMAN VOLCKER. It's a relevant question in a way: How do we do better than these numbers? Mr. Roberts, maybe you can tell us.

MR. ROBERTS. I really can't help you much on that; I'm sorry. I have two comments, which are sort of questions. On the productivity, I guess you took into account this major change from manufacturing to services in the 1970s as one of the factors holding back productivity. With services now such a large part of the economy, would that from here on out tend to cause the same or an increased rate of productivity if it stabilized, let's say?

MS. ZICKLER. The bulk of the research that was done, as we discussed earlier, was unable to pin that down for the 1970s. Most of the research showed that productivity slowed in service industries as well as in manufacturing industries. The pattern of the slowdown was at least the same across different types of industries, so we were unable to pin this productivity slowdown on the growing services sector. Looking ahead and having the services sector be one of the growing sectors, I'm not sure that that should detract from the things that seem to be important in the productivity slowdown, however undefined they may be. There are some technological changes that could affect the services sector as well as manufacturing.

MR. ROBERTS. That really is the point that I was coming to. I think maybe some of the drag in productivity in the services sector is now being overcome. Productivity is coming to the services sector. And if you have lower [productivity in the] manufacturing sector also as [the staff] has here--I'm just saying that I think productivity estimates are too low for the short run anyway. Then I had a question. I'm intrigued by this expectations effect on inflation. Do I understand this correctly: That if someone expects inflation, it's more likely to happen regardless of the policies in effect? That is, if a person loses his job, even though he has expected inflation, it's more likely to happen although the conditions are [such as] to cause him to be unemployed?

MR. STOCKTON. Certainly, if we think of expectations in a more general sense, obviously, the price expectations of the person who is unemployed are exerting less influence on current wage negotiations than those of the person who is employed. But our general feeling is that the level of expectations of future inflation is critical in determining the entire environment in which wages and prices are being determined. We have situations where people have [negotiations] going on for three-year contracts and they have to form expectations about inflation over a three-to-four year horizon. We have businesses making contractual commitments based on expectations. It's certainly the policies that will influence the actual outcome; but if we were to hold policies constant and increase everybody's inflation expectations by 2 or 3 percent, we think that would lead to higher inflation.

MR. ROBERTS. I guess what I don't see is how, if inflation expectations rise and policies are in place so that the sales can't be made at the higher prices, that really would affect real inflation. It might in the very short run.

MR. STOCKTON. Inflation in that case would be lower than people perhaps had expected. But the fact that they had expected higher inflation would have been a marginal contribution to the higher inflation.

MR. ROBERTS. It would make it tougher for the policies to work.

MS. TEETERS. Is the message you are trying to deliver here that the credible disinflationary policy is basically a long period of very high real interest rates and high unemployment? Is that the only way we can obtain low or close to zero inflation?

MR. KICHLINE. No. That was not the intent. The intent was to do this exercise and to look at what comes out and then recognize that, indeed, we're using a model that has some deficiencies. All models do. Outcomes can differ; they can be better or worse. And we've tried to focus on those things that we felt could be important in reducing the costs or raising the costs from a baseline case. So, it was really designed to be illustrative. And then one can think about those things that over the longer run might cause the outcome to be better or worse.

CHAIRMAN VOLCKER. I think that's precisely right. I think that they set themselves up here as a big fat target, and it's not a very--

MR. KICHLINE. I might say it was at someone's request!

CHAIRMAN VOLCKER. It's useful. It shows the result. It is meant to be a vehicle for discussing how to get a better result.

VICE CHAIRMAN SOLOMON. I think, though, that the result is even worse than you have there. You have real interest rates rising steadily from present levels to a point where eventually they are about 4 percentage points or so higher than they are now. I find it inconceivable that we wouldn't have a recession in this period. And for a period of time we would have a much higher level of unemployment than you have. At least that seems to me more likely.

CHAIRMAN VOLCKER. If that's right, then we would also get a lower level of prices.

VICE CHAIRMAN SOLOMON. That's right. I guess I would say that is a slightly better scenario. I wouldn't want to be quoted on this but it seems to me that a more realistic scenario would be a monetary policy that keeps inflation in the 4 to 5 percent range for the rest of the recovery and then one would hope that a normal cyclical recession at that point would cut the inflation rate down to maybe half of that and get it to the 2 to 3 percent range. It seems to me that, in terms of all the elements that have to be accommodated, that is a more realistic way of trying to work toward long-run price stability.

CHAIRMAN VOLCKER. Well, let's examine that proposition. I'll let Mr. Gramley answer that.

MR. GRAMLEY. I would like to ask the staff this question. Did you by any chance turn this exercise on its head and say: Suppose we were to walk the unemployment rate down gradually to the natural rate by 1988? What results do you get then? I don't think they are going to be all that bad, really.

MR. STOCKTON. In fact, we have done that exercise, and doing that we end up with an inflation rate a little under 4 percent by 1988 and the unemployment rate would have gotten down to about 7 percent at that time.

MR. GRAMLEY. And if we accept the definition of price stability of the President of the Federal Reserve Bank of Minneapolis, we're almost there.

CHAIRMAN VOLCKER. It surprises me a little that you get that answer based upon these numbers. You get the unemployment rate down to where? The natural rate is 6-1/2 percent?

MR. STOCKTON. Seven.

MR. GRAMLEY. If you just take the straight Phillips curve approach to it and make some rough ballpark calculations, leaving out what happens to the exchange value of the dollar, it looks as if you ought to be able to get [unemployment] even lower than that. I suppose you have a very different effect on the dollar.

CHAIRMAN VOLCKER. How can you? If the unemployment rate went down steadily, you would be bound to have a higher inflation rate in 1985, right?

MR. STOCKTON. That's correct. The inflation rate goes to about 4-1/2 to 5 percent in '85, back down to 4-1/2 percent in '86, about 4-1/4 percent in '87, and a little under 4 percent in '88.

MR. GRAMLEY. You're always above the natural rate of unemployment. All that is happening then, if you reduce the extent to which you get improvement, is that you have the speed limit effect. The speed limit effect in any case is one that has been much in dispute; not everybody believes the speed limit hypothesis. But if you threw that out, you would get even better performance.

MR. PARTEE. May I just tack on to Tony's question? I was bothered by that too. You just threw out a number on interest rates in 1988 and I'm not sure I heard it correctly. I thought you said 9 percent or so for the funds rate. Is that with a \$120 billion improvement in the budget situation?

MR. STOCKTON. That's right. The actual budget deficits, of course, still remain fairly high, but you get much weaker--

MR. PARTEE. Yes, it's a \$120 billion better budget deficit than otherwise--that is, without a change in policy occurring. And there's still a 9 percent funds rate with a 1 percent rate of inflation? That sounds extraordinarily tough.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. I'd like to come back just a second to this inflation expectation problem that, as you said, your model can't incorporate. As I look at today's Bluebook and the structure of the alternatives there between alternative A and alternative C, the interest rate levels projected show the T-bill rate going down to the 8 to 8-1/2 percent range under alternative A with a slight drop in long rates. And in alternative C the T-bill rate is up in the 9-1/4 to 9-3/4 percent range with a slight rise in long rates. My question is: Given the dramatic drop in inflation we've already had, what is holding interest rates up at those levels? Might it not, in fact, be inflation expectations?

MR. AXILROD. I can spare them an answer. I don't think these people have been involved in the rates. You might want to wait for another 20 minutes or so.

MR. BALLE. I'd rather not wait, but if you have an answer I guess--

MR. AXILROD. I was a little [reluctant] because there is a large group of people here who don't attend the regular meetings.

MR. BALLE. I'm sorry.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. If I understand the Phillips curve analysis properly, your inflation forecast depends upon the markup over cost. Is it possible that international competition could intensify to the point that that could be very difficult to accomplish and significantly affect your inflation forecast?

MS. ZICKLER. That the market could be--

MR. BLACK. Reduced.

MS. ZICKLER. Oh yes, that's a possibility. In fact, we have to take into account rising import prices--that there would be domestic goods that compete with imports, and normally you would expect [producers] to be able to raise their prices. But if that competition is great, the market is limited and they may not be able to do that.

CHAIRMAN VOLCKER. But you're assuming a sizable depreciation in the dollar, so all those import prices are going to go up.

MS. ZICKLER. Correct.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Perhaps you said it and I missed it. What is your expectation with regard to labor contract settlements over this period? The question has a basis--namely, that an awful lot of people I've talked to are currently settling contracts in the 6 percent area with 3-year contract periods. But they do suggest that, whereas they are sanguine about being able to hold this for the rest of this year and for 1984, as they get further out corporate profits really begin to improve. I guess most people expect corporate profits to be very



good over the next few years and [thus] it's going to be very, very hard to maintain that [pattern of wage increases]. There are still some COLAs around, and the expectation is that contract settlements will begin to move back up. What kind of settlement number do you have in mind during this period?

MR. KICHLIN. 5-1/2 percent.

MS. ZICKLER. The staff projection through 1984 has something close to a 5-1/2 percent increase on hourly compensation. Now, the data that we've seen on contract settlements so far this year have been on average about 4-1/2 percent, I think, rather than 6 percent. But I don't deny that there are some industries that are returning to profitability where workers are going to be looking for larger settlements. Within the context of our forecast, in 1984 the petroleum industry bargains in January and then there's nothing very much going on until we get to the auto [industry negotiations]. By the time we get to the end of '84, moving into '85, we will start to see some of these contracts turn over where there had been concessions and some recognition that profits were low. And we would expect by 1985 to start to see larger wage settlements. I haven't thought through exactly what we're going to put down when we extend our forecast, but we would be looking for larger settlements.

MR. CORRIGAN. In some ways that's the other side of the productivity point, because to the extent they get a lot more productivity they're going to get more profits and more cash flow; that, in turn, will solidify even further on the part of labor [their resolve] to get their piece of the action.

VICE CHAIRMAN SOLOMON. Well, we could get a recession in 1986, which will head off unfavorable contract negotiations.

CHAIRMAN VOLCKER. By 1986 we will have had, with or without a recession, 5 straight years of the consumer price index [in this projection] being less than 4-1/2 percent. So, why should they accelerate beyond 6 percent? That's your number.

MR. STOCKTON. Well, Joyce was referring not to this 5-year scenario, but rather to--

MS. ZICKLER. --the staff projection. In the staff projection, we had consumer prices in 1984 up around 5 percent.

MR. STOCKTON. About 5-1/4 percent.

VICE CHAIRMAN SOLOMON. But I think one could argue, Paul, that even if inflation continues at only 4 percent or 4-1/2 percent or whatever, that we would still get a net increase in wage compensation beyond 6 percent for this reason: The only way we get today's low average is by having extremely depressed wages and absolute cuts in many manufacturing industries. It's running much higher, as you point out, in utilities and the financial sector, etc. So, if we have recovery in the smoke-stack area--even if inflation is still in this [4 to 4-1/2 percent] area--we probably will end up with a higher average wage in the country as a whole.

CHAIRMAN VOLCKER. You read my speech!

MS. TEETERS. But in this projection, on chart 18 you don't have tremendous increases in corporate profits and, therefore, you don't have the upward pressure on wages.

MS. ZICKLER. Chart 18 is not a staff forecast, necessarily.

MS. TEETERS. No, but if we had the scenario in which--

MR. KICHLIN. No, that's right. If we have low real growth, we would not have a very bullish outlook for corporate profits.

MS. TEETERS. And as a result, that's part of the mechanism by which you get a lowering of the inflation rate in there.

MR. CORRIGAN. Yes, but some of that probably is already built in. Look at the auto industry: The best guess now seems to be that this year the auto industry is going to earn \$5 billion in profits, and that's in a context in which not insignificant concessions have been made across the board in a setting in which the wages are too darn high to begin with. I would just speculate, even on the basis of what has happened this year, that trying to hold wages in the automobile industry in any reasonable proportion is going to be very difficult with that \$5 billion in profits there.

CHAIRMAN VOLCKER. Let me ask a couple of questions. If you extended this assumption for M2, the monetary policy proxy, of 4-1/2 percent for three more years--you seem to have a zero velocity in here, roughly--what is going to happen to prices and real GNP in '89, '90, and '91?

MR. SLIFMAN. Well, zero velocity doesn't [unintelligible].

CHAIRMAN VOLCKER. Would you still have inflation under those assumptions? You have an unemployment rate 1-1/2 or 1-3/4 percentage points above the natural rate.

MR. STOCKTON. In '88 and '89 you probably would not have positive inflation, but eventually your long-run equilibrium would give you slightly positive inflation if you have 4 percent M2. So, you could probably have slightly lower M2 in the long run consistent with price stability.

CHAIRMAN VOLCKER. It would go into minus prices and then it would go plus again.

MR. STOCKTON. Yes, that's the likely outcome.

MR. PARTEE. You're getting close to the long run now, corresponding between money and prices--

CHAIRMAN VOLCKER. I don't know whether we ever get to that; it takes 8 years to get to the long run on this model. Suppose--the obvious question--you cut all these money figures quickly and then level them off. Where would things go?

MR. STOCKTON. Well, we'd probably get a recession or some contraction in output in the '85-'86 period and that would get the inflation rate down that much faster.

CHAIRMAN VOLCKER. Where would we end up in '88: a lower rate of unemployment?

MR. STOCKTON. Well--

MR. ENZLER. Those kinds of questions are very hard to answer. Certainly, if you got more unemployment sooner, which that would cause, it would be possible to end up with a slightly lower rate of unemployment at the end that would still be consistent with price stability. But I can't simulate in my head what would happen.

CHAIRMAN VOLCKER. Is there some monetarist here who will give us a much more favorable hypothesis and explain it?

MR. GRAMLEY. Well, in light of the results in chart 17, the remarkable thing is how well the Phillips curve model has done to explain what actually has happened. It got a little off track for a while in 1981, but in terms of the overall performance of the economy from 1978 on it has done very, very well indeed. So, I think the result that the staff is presenting to us is eminently reasonable in terms of outcome. If what you want to do is get back to price stability, this is what you're going to have to suffer. And if you want to get back to the natural rate of unemployment, you're going to have to have a worse inflation outlook.

CHAIRMAN VOLCKER. The Phillips curve in Chart 7 doesn't look so good.

MR. BLACK. Well, didn't Henry put his finger on it a while ago in pointing out that we can't incorporate expectations in there to the extent that we probably should? That's the great missing thing, it seems to me.

MS. ZICKLER. Well, to some extent the Phillips curves in Chart 7 move across the page as the natural rate is rising and shift up to the extent that inflation expectations were higher in the '70s than in the '60s.

MR. GRAMLEY. Yes, I don't think Chart 7 at all contradicts what is in Chart 17.

VICE CHAIRMAN SOLOMON. Okay, but counting Chart 17 [unintelligible], assuming that there is that correlation, what level of unemployment do you have to have to get price stability in 1988?

MS. ZICKLER. In the quarterly model?

VICE CHAIRMAN SOLOMON. You come back to the same conclusion as your baseline.

MS. ZICKLER. The quarterly model is in the 6-1/2 to 7 percent area as well; that's the natural rate implicit in the model.

MS. TEETERS. Shouldn't the natural rate be coming down over the decade of the '80s?

MS. ZICKLER. Right. To the extent that we get better productivity performance, that should lower it. And to the extent

that the demographics favor less of the sort of frictional unemployment that was associated with the rapid rise in the labor force in the '70s, that should bring the natural rate down.

CHAIRMAN VOLCKER. I can make a simple point that if you're not ready to attack the model, you have to live with it. Do you want to attack it, Mr. Corrigan?

MR. CORRIGAN. No. I think there's some good news and some bad news. The bad news is: My hunch is that, if anything, the model as we're talking about it here probably underestimates the amount of inflationary pressure in this period, even though I would agree that it's likely that we're going to have more productivity growth than the model suggests. My reason is that I think inflationary expectations, however latent, are probably stronger than this model contemplates. And I continue to believe that the speed effect, if that's what it's called, in the short run will hurt quite a bit if prices even begin to pick up moderately--say, gravitate up to 5 percent.

VICE CHAIRMAN SOLOMON. What is the inflationary expectations assumption of this model?

MR. CORRIGAN. I assume, and maybe I'm wrong, that it's something like what is in that early chart, which basically says 4 percent.

MR. STOCKTON. It's a weighted average of past rates--probably more like 5 percent.

MS. ZICKLER. That weighted average that's on Chart 13 is just geometrically declining weights. It's similar to most of the econometric [models with] distributive lags, and that's 4-1/2 to 5 percent.

CHAIRMAN VOLCKER. Suppose you magically changed that in your model and made it 1 percentage point lower. What would that do?

MR. STOCKTON. The inflation rate that we're projecting right along that path would come down 1 percentage point.

CHAIRMAN VOLCKER. One whole percentage point.

MR. STOCKTON. That's correct.

MR. CORRIGAN. But the converse is also true.

STAFF(?) Or one could lower the unemployment by maybe a percentage point.

MR. MORRIS. One thing clear from Chart 13 is that the consumer--

CHAIRMAN VOLCKER. Wouldn't both happen? If monetary policy and everything else is unchanged except you have some deus ex machina here that gets inflation expectations down 1 percentage point, the inflation rate would be down 1 percentage point and the unemployment rate would be down too.

STAFF(?) Initially the inflation rate goes down, but I think eventually the unemployment rate would end up lower too.

MR. CORRIGAN. Would you like to hear my good news?

CHAIRMAN VOLCKER. Not if it's like your bad news!

MR. CORRIGAN. My good news is that some of my staff have developed an alternate model, which is a very interesting model. It basically says that the deficit over time effectively has to be financed through inflation, with a very direct connection between the size of the deficit and the amount of inflation in the system. Now, working backwards from that, we're going to see a happy result because this suggests that if you could eliminate the deficit net of interest payments, which are roughly \$65 or \$70 billion, quickly--say, in a period of a couple of years--you could find yourself with the happy result of a combination of real growth of around 3 percent and real interest rates of around 3 percent. I don't believe that, necessarily--

CHAIRMAN VOLCKER. The inflation rate is where?

MR. CORRIGAN. The inflation rate effectively would be zero or something close to it.

CHAIRMAN VOLCKER. What does the staff say about that?

MR. KICHLINE. I've never fully understood that approach. I think that assumes, President Corrigan, that debt equals money.

MR. CORRIGAN. Yes.

MR. KICHLINE. It assumes that Treasury bonds equal M1, and it's just hard for me to relate those as one to one. One can spend Treasury bonds as readily as currency, perhaps--

MR. CORRIGAN. No, I don't think you have to associate them rigorously, but it does say that financing the deficit in effect can only be done in one of two ways: through new money, however defined, or through inflation. But if you get rid of the deficit and you get rid of that constraint, then you can have real growth and the real interest rate at about the same level, 3 or 4 percent.

MR. ROBERTS. Finance the deficit from overseas.

MR. GRAMLEY. But if you believe that theory, how would you explain what is on Chart 1?

MR. CORRIGAN. You couldn't.

VICE CHAIRMAN SOLOMON. Turning to something else: You show a one for one--

MR. CORRIGAN. You couldn't explain Chart 1, but it does provide to me a more useful framework for being able to answer the question of how the deficit gets into all this. And it doesn't produce the kind of perverse result we get here, which says you get a better result if you increase the deficit.

MR. GRAMLEY. Well, but that's kind of a technical answer out of a model which goes through the exchange rate.

SPEAKER(?). That's right.

MR. GRAMLEY. It doesn't say what kind of political pressures evolve when high interest rates begin to upset the capital goods industries and residential construction and the export industries get devastated and trading partners complain a lot. All those exogenous factors no longer stay unchanged. When you build a model that endogenizes a lot of these responses, which never would take place, you would get different answers. I don't know how you could argue seriously that in the long run the only way to finance a deficit is through money growth or inflation. That to me makes no sense. I'm not a monetarist, but if you give me 30 years, I have to believe that what happens to the money stock primarily determines what happens to prices.

MR. CORRIGAN. All right, but that view is not incompatible, because it comes down to the same thing. It would say in that case that you will end up with more inflation because the deficit in effect forced you to create more money.

MR. GRAMLEY. Yes, except if you go back to these 30 years in Chart 1, they were years in which the federal deficit as a percentage of GNP was dropping like a stone.

MR. CORRIGAN. Well, for that whole period going back to the 1950s, the federal deficit net of interest payments was basically zero until two years ago. For that whole period it was basically zero.

MR. WALLICH. This theory is based on the assumption, isn't it, that there's some limit to the volume of government bonds that the public is willing to hold and that, therefore, necessarily a continuing deficit leads to monetization? I don't know what that assumption is based on, but the ratio of debt to GNP has been very stable over a long period of time regardless of how the debt was made up. The debt was large in terms of public debt, and private debt was small; and later it changed to less public and more private debt. Now it has been changing back to a greater proportion of public debt and smaller private debt. Throughout, the relationship of total debt to GNP has been very stable.

MR. CORRIGAN. But look out from where we are now and take the latest CBO estimates of the deficits out to 1985. If you take out interest payments and look at it that way, as a percentage of GNP there is no precedent in the postwar period for the kind of phenomena we're looking at in the period from now to 1988.

MR. WALLICH. Well, doesn't that mean that private debt creation will be very small, which is the phenomenon referred to as "crowding out"?

MR. CORRIGAN. And interest rates are very high and growth is very low.

MR. WALLICH. That's exactly right.

MR. BALLE. And a large part of the deficit is financed by imported capital, which is what is going on right now.

MR. WALLICH. The general impression I get from this model, frankly--aside from congratulating you on having the courage to remain at zero inflation, which was by request--

MR. KICHLIN. False courage!

MR. WALLICH. [Unintelligible], which I think people believe would change the nature of the problem. I see this, as Tony Solomon does, as a cyclical problem: The economy probably will go into recession one way or another after two or three years or a little more after the last drop. And what your model seems to say is that it will take more than one more recession in order to get to zero [inflation]. The next recession will start from 5 or 6 percent inflation and we can cut inflation in half again. But that's not enough, so we have another expansion of two to three years from a lower starting point. And then maybe the next recession will get us close to zero.

VICE CHAIRMAN SOLOMON. And to continue on that line, since you say in the earlier pages that if you have a 1 percentage point less rapid rate of growth in '84 and '85, you get 1 percentage point less inflation in '84 and '85: If you were basically following a policy along the lines Governor Wallich and I are talking about, is there any additional reduced inflation payoff of running, say, a 1 percentage point lower rate of growth in the next year or two, recognizing that what you're really trying to do in the broadest policy sense is to contain inflation just where it is during the recovery and then take advantage of the next recession to bring it down somewhat more? Is there a significant advantage in running a lower growth rate over the next two years--that's basically a cyclical view--rather than doing this?

MR. STOCKTON. Over the next two years--again we have to run slow growth just to contain those factors, we think--there may be a loosening of inflation. But--

VICE CHAIRMAN SOLOMON. Unless you're lucky on some of the other things, such as productivity and a couple of other things--

MR. MARTIN. Let me tie on to that with a collateral question: Is there a one-to-one unemployment increase if you, let's say, come down 1 percent in the rate of growth with contained inflation?

MR. STOCKTON. No. Normally we think that every one percent on growth might be 4/10ths on [the unemployment rate]. But the problem is that it's hard to see any major advantages within the structure of the model to pursuing what you're recommending. That is, you may get benefits from lower inflation and the value of the dollar. But again you have to pay back part of that once the economy begins to go upward. You may get lower benefits from concessions on compensation, but you may have to pay back part of that. The benefit you get from running lower output early is lower inflation expectations for the remaining periods of the simulation. In that sense, the sooner you reduce output, the easier it is to bring down

inflation because you've lowered inflation expectations for all subsequent periods.

VICE CHAIRMAN SOLOMON. I understand that. But if we were able to prevent the rate of inflation from going up beyond the present level during the rest of this recovery, though I don't think we will be, I would guess that there would be a very, very widespread expectation in the financial community that the next recession would bring the rate of inflation down significantly. We would get a very favorable expectational result if, over the next year or year-and-a-half, we could stabilize this level of inflation.

CHAIRMAN VOLCKER. This level meaning what?

VICE CHAIRMAN SOLOMON. 4 or 4-1/2 percent. The [financial] community is expecting basically a 1 to 2 percentage point rise in the rate of inflation over the next 2 years.

MR. GUFFEY. Well, it seems clear that that is our task: to keep it from accelerating. And that's what their model shows--the way we get it. If in '84 and '85 we're going--

CHAIRMAN VOLCKER. This model shows [that we get it] with a more restrictive monetary policy than what we have heretofore talked about, if I read it correctly.

VICE CHAIRMAN SOLOMON. Well, what does it assume for velocity of circulation for M2? If we drop [M2 growth] to 6 percent in 1984, what velocity of circulation does that assume?

MR. PARTEE. Between [unintelligible] and 4.2 percent increase in velocity in '84 and a lower increase in velocity in '85.

VICE CHAIRMAN SOLOMON. Yes, but isn't that a lower velocity than we normally adhere to?

MR. WALLICH. It drops each year. Eventually, velocity drops because the nominal GNP is less than M2.

MR. PARTEE. Yes, it does.

MR. WALLICH. It does unless interest rates--. If you let interest rates rise as you seem to [assume] here, velocity ought to increase.

MR. PRELL. Interest rates are declining in the latter part of this projection period and that is giving you some decline in velocity--some stronger demand for M2 relative to GNP. That wouldn't be a continuing factor, if you extended this out beyond 1988, but it's a factor in 1987 and 1988.

CHAIRMAN VOLCKER. What assumption do you make about M2 or M1 or anything--zero [effect] except as it affects nominal GNP?

MR. STOCKTON. That's correct. It doesn't have a direct expectational effect.



VICE CHAIRMAN SOLOMON. But it has an interest rate effect in your model, doesn't it?

MR. STOCKTON. Oh, sure; that's the channel.

MR. KICHLINE. I thought you were referring to expectations. There's no feedback effect on price expectations from altering money growth.

CHAIRMAN VOLCKER. You have two columns here. It doesn't tell you anything--it's some pure guess--about velocity.

MR. KICHLINE. Well, it's a model that in effect--

CHAIRMAN VOLCKER. It's a guess; it's your model of velocity. But its influence [unintelligible] model. Well, I'm left with my question to the group, not to the staff: Either accept something like this model, [which has] satisfactory results from most points of view, I guess, or say how you would change any of these factors to get better results. You have to come up with a better model or a different model if you don't like these results.

MR. MORRIS. Well, I think a different model, like the one that Tony talked about that incorporates--

CHAIRMAN VOLCKER. I don't think that's really a different model. There's a different timing with inflation [unintelligible]. But you don't have different factors to play around with; [you have] the same variables.

MR. MORRIS. If you plugged in a couple of recessions in the model, you'd get different results.

MR. MARTIN. Or higher productivity.

CHAIRMAN VOLCKER. You would get different numbers, but you're still using the same model.

VICE CHAIRMAN SOLOMON. I think the expectation, as I was trying to say earlier, is a little different and the scenario is different. If you contain the existing rate of inflation during the recovery, you will get a very significant drop in inflationary expectations in another couple of years. That, I think, is significant in working the model.

MR. CORRIGAN. I think that's the key: If we could cap inflation at 4 to 4-1/4 percent, while the economy for the next two years is growing at, say, 4 percent.

MS. TEETERS. But that doesn't work. That's not what this says. It says the faster the economy grows, the more inflation you're going to get. As nice as it would be to cap the inflation, we don't have any way to do it except by slow growth.

MR. GRAMLEY. It would be nice if the world worked the way Tony wants it to.

MS. TEETERS. Yes.

MR. GRAMLEY. But we've just been through an experience in which the Fed said to the world in 1979: Here it comes, guys; we're going to put you through the wringer. And what we got, if you believe the model, and there have been other studies that confirmed this, was by-and-large the response of prices to the degree of slack in the markets--period, end of story. Now the question is: Why do you think it's going to work any differently the next time around? It would be nice if you were right, Tony, but I don't--

VICE CHAIRMAN SOLOMON. I'm not saying it's going to be right or that this is going to happen automatically. And I don't want you to assume that I'm going to vote the way I'm now going to suggest. But if we reduce the speed of recovery by 1 percentage point over the next year and we get 1-1/2 to 2 percent growth, and assume no action on the deficit until 1985 and then only half of what we are thinking at this time, I was wondering what that would look like. We might very well not have any increase in inflation in the next couple of years because of the exchange rate effects as well. Maybe you fellows worked this out roughly: A 1 percent lower rate of recovery over the next two years during this--

MR. PARTEE. This package is 3.3 percent next year and 1.5 percent the year after.

VICE CHAIRMAN SOLOMON. I'm talking about this earlier scenario.

MR. KICHLINE. You're talking about chart 15--the staff projection chart--not the experiment over 5 years. And there we have assumed, I think, a 4-1/4 percent rate of growth in 1984.

CHAIRMAN VOLCKER. Well, they already assumed a 1 percentage point lower growth in the briefing.

VICE CHAIRMAN SOLOMON. You have already assumed in '84 and in '85--

MR. KICHLINE. Yes, this says you can hold the inflation rate constant with essentially a little over 3 percent real growth in 1984 and a little under 3 percent in 1985.

CHAIRMAN VOLCKER. In '84 and '85 we have reduced [real GNP growth], if I understand it.

VICE CHAIRMAN SOLOMON. Well, I don't understand that because chart 18 has 3.3 percent in '84 and 1.5 percent in '85.

CHAIRMAN VOLCKER. I think it's 1 percentage point lower than they otherwise--

MS. ZICKLER. Chart 18 is not the staff projection. Chart 18 is the model projection, not the staff forecast as shown in the Greenbook projection. Chart 15 represents our forecast.

VICE CHAIRMAN SOLOMON. Okay. But at the moment in the real world we are assuming that growth in 1984, if we were to continue with the present monetary policy, is likely to be 5-1/2 percent. At least

that's what we are assuming in New York; it's higher than you people have.

CHAIRMAN VOLCKER. And we are assuming 4-1/4 percent.

MR. KICHLINE. 4-1/4 percent.

VICE CHAIRMAN SOLOMON. With the present monetary policy? So, we are assuming significantly higher growth. Am I right on that, Peter?

MR. FOUSEK. 5-1/4 percent.

VICE CHAIRMAN SOLOMON. Okay, 5-1/4 not 5-1/2 percent. And I'm saying--well, I guess you can't compare the rates.

CHAIRMAN VOLCKER. You're assuming 5-1/4 percent with this same inflation prediction?

VICE CHAIRMAN SOLOMON. Our inflation prediction is somewhat higher; I think we have a rate 3/4 of a point higher than the Board staff has.

MR. GUFFEY. With the current monetary growth rate as your assumption for '84? Without any reduction in money growth?

VICE CHAIRMAN SOLOMON. We are assuming basically that we have a 9-1/2 percent fed funds rate.

MR. GUFFEY. Now, what about money growth?

VICE CHAIRMAN SOLOMON. I don't worry about that.

CHAIRMAN VOLCKER. It's 5-1/4 percent real growth if they have 5-1/2 percent on prices.

MR. KICHLINE. Yes, [unintelligible] in the same ballpark because you are talking about roughly 1 percentage point. That's the real growth, and we would have a higher price forecast for that.

VICE CHAIRMAN SOLOMON. So, in other words, if I'm correct: To maintain 4 to 4-1/2 percent inflation, assuming that's what we have now, you would have to cut back real economic growth in '84 according to your model to what level?

MR. KICHLINE. Well, in 1984 real growth would be in the area of 3 to 3-1/2 percent and in 1985 2-1/2 to 3 percent.

VICE CHAIRMAN SOLOMON. But if you had 1 point more in productivity, you wouldn't have to cut back quite that much?

MR. KICHLINE. That's right. They're about offsetting. If you get that 1 percent higher trend growth of productivity, then you could get the same inflation outcome that we have without cutting back on real growth.

CHAIRMAN VOLCKER. Well, does anybody else want to comment? Mr. Wallace.

MR. WALLACE. May I ask a question for clarification on this natural rate of unemployment? With respect to the factors that you've listed on chart 8 here: Is it your assumption that on balance the thrust of those factors would reduce the natural rate in the year ahead rather than the productivity that you talked about?

MS. ZICKLER. No, as a matter of fact, on income support programs there has been some cutback--more stringent eligibility requirements introduced on unemployment insurance and benefits--which should work to reduce the natural rate. Those sorts of things are hard to estimate. And to the extent that we have seen some improvement in work rules and labor/management relations, that makes the labor market a little more flexible. [Those are] conditions that would help. But that has been continuing as the recovery goes on.

MS. TEETERS. But the most important thing in reducing the real natural rate of unemployment is the shifting demographics.

MS. ZICKLER. Well, I think the sharp [deceleration] of productivity growth was far more important in and of itself in the '70s than the demographics, in terms of the percentage points that added to the natural rate. On the demographics I think the story is a little uncertain. You have to assume that all these workers who have come into the labor force have been getting work experience and have developed career attachments to jobs. As that happens they improve their job performance.

MS. TEETERS. Yes, but just the demographics are going to reduce the rate of growth in the labor force.

MS. ZICKLER. Oh, in terms of the major unemployment rate, yes.

MR. MORRIS. I think the answer is clear, Mr. Chairman: We have to get the productivity gain up to 4 percent. That would take care of the whole thing!

VICE CHAIRMAN SOLOMON. If capacity is increasing at less than the postwar average or [unintelligible]. So, at this speed of recovery, at least it's a normal recovery but we are moving up faster in utilization of capacity. This is where the Carter Administration ran into trouble quickly because there was a theory that utilization of capacity was supposed to [unintelligible] noninflationary growth [unintelligible]. I've put a lot of emphasis on capacity utilization. And it's very disturbing not to have it growing at a normal rate, even though we're having a fast recovery. I attribute this to the inflation rate. However, we are getting a lot of spending on equipment but not on plant; presumably the spending on equipment will extend the rate of productivity for [existing plants].

CHAIRMAN VOLCKER. Well, I think we can leave this for the day. But I would urge people to look at this question. I think we have a rather pessimistic [unintelligible]. But I have not heard a great deal of attacking of this today. You're simply saying we are better off with higher productivity if we could only achieve that. They can have a wrong estimate. But people might want to think a little about how we can improve this situation or even [unintelligible]. We will attend to it briefly at the next meeting.

If we have enough time, maybe we can go through the Managers' reports this afternoon.

MR. BALLE. Mr. Chairman, I wonder if in this review at the next meeting we could have the advantage of having sent to us the text of the staff's views given in the chart show today so that our own staffs may work on an analysis. We'll see if our [unintelligible] and weigh them a little.

MR. KICHLIN. Well, there's no problem there.

CHAIRMAN VOLCKER. I think there's a little more to be considered, consistent with that. This is very much internal staff speculation. It has no Committee status and there's no Committee--

VICE CHAIRMAN SOLOMON. It seem to me that the [unintelligible] means more optimistic. But I would like to know how to be able to avoid a significant effect rather than a lower growth with such an elusive combination of--

CHAIRMAN VOLCKER. Well, I think you may be taking it too literally. I don't think this is a business cycle forecast. It's kind of a structural forecast with growth tradeoff [unintelligible] of these recessions.

MR. MARTIN. It depends on when you have recessions--

VICE CHAIRMAN SOLOMON. [Unintelligible] factors cyclical. It's unlikely that the recovery would last beyond '87. I don't even think we should wait until '87; we ought to go for '86. And if you factor in an enormous [unintelligible] then we could get worse inflation. I don't know how to look at this kind of policy.

MR. BOEHNE. Are you talking about an improvement in the presentational sense or one that we really believe?

CHAIRMAN VOLCKER. I'm only interested in what we can believe.

MR. BALLE. That's right.

CHAIRMAN VOLCKER. Or have somebody believe; it may have some correlation in the presentation.

MR. WALLICH. Well, I think the main thing is to be skeptical with respect to the model even though it has tracked very well in the last two years, because the very fact that it has tracked well and inflation came down is a surprise to people. And from here on out there may be less resistance because there was a lot of resistance to bringing inflation down built into the numbers of this model.

CHAIRMAN VOLCKER. I'm curious, but I won't prolong this, how you get this similar result from a long lag money growth model and a short lag money growth model in the chart that has the deflator and M1. This M1 only goes through '81. Do I interpret that correctly?

MR. KICHLIN. Which chart?

CHAIRMAN VOLCKER. Chart 2.

MR. KICHLINE. That's right.

CHAIRMAN VOLCKER. I don't remember a 10 percent rate of growth--maybe in 1981.

MR. BOEHNE. Do you think, Jim, if you had made this presentation three years ago, that under any realistic kind of model you would have come up with 4-1/2 percent inflation?

MR. KICHLINE. If you told me that the unemployment rate was going to be over 10 percent, I think we would have come out fairly optimistic. I wouldn't say that our staff view on inflation has been much more optimistic generally than outside forecasts; outsiders beginning in 1982 have moved their forecasts down substantially relative to the staff forecast. Now as we look ahead to '84 and what is happening in light of a lower unemployment rate, our staff forecast has been edging up. So, I'm not so sure. We wouldn't have had 4-1/2 percent inflation, but I'd say we would have had in the context of 10 percent plus unemployment rates, very strong improvement on price performance. But we missed on that, as you well know.

VICE CHAIRMAN SOLOMON. So did we all.

MR. PARTEE. And the strength of the dollar.

MR. KICHLINE. Yes, right.

CHAIRMAN VOLCKER. On a purely monetarist approach here: If you looked at this first chart, chart 2, you would have the money supply lower. You've got its growth coming down to below that of the [deflator] for a while and kind of coming back in line with prices, right?

MR. KICHLINE. [Unintelligible] based on recent performance.

CHAIRMAN VOLCKER. Then you would show a sharp increase, which would imply a sharp increase in unemployment at the same time we were going into a recession if we maintained the recent rate of growth of the money supply.

MR. KICHLINE. I think that's right. That shaded area is the area where there are some questions about the performance of the money stock relative to nominal spending and that was part of Steve's presentation last time. And that's where the--

CHAIRMAN VOLCKER. Oh, this is really before the most severe [unintelligible]. This money supply stops in mid-1981.

MR. PARTEE. That would be in the summer--the third quarter of '81. You only plotted M1 through the third quarter of '81, so there's another spike in here.

CHAIRMAN VOLCKER. Because if you get in there-- Well, Mr. Sternlight. No. First, the meeting has to come to order and we need to approve the minutes.

MR. RICE. So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Well, you might explain why you need a larger leeway.

MR. STERNLIGHT. Over the intermeeting period our projections indicate a possible need to add something in the area of \$4 to \$5 billion to System holdings, and I think we could run into the normal \$4 billion intermeeting limitation. I would suggest enlarging the leeway to \$5 billion until the next meeting, Mr. Chairman.

MS. TEETERS. Is that an average figure? Is it that it can't be over \$4 billion on average?

MR. STERNLIGHT. It's not an average, no. At any point within the period we would not be able to increase outright holdings by more than \$4 billion from the starting point.

MS. TEETERS. I was wondering because that doesn't include the repurchase agreements.

MR. STERNLIGHT. It does not include the repurchase agreements.

MS. TEETERS. So, the big operations--whether the Treasury balance is running out or not--are not the subject of this.

MR. STERNLIGHT. That is true. Correct.

CHAIRMAN VOLCKER. You don't have any limit on your repurchase agreements?

MR. STERNLIGHT. That's true.

VICE CHAIRMAN SOLOMON. As Mr. St Germain pointed out. About a year ago he wrote me a letter, which was in the press, asking: Why are you doing such a huge volume of RPs? We wrote back explaining the reasons why and I never heard from him again.

MR. STERNLIGHT. On a commitment basis we're not changing the System's holdings [when we do RPs].

VICE CHAIRMAN SOLOMON. You have had to ask every once in a while before, Peter, for this kind of temporary increase in the limit. Wouldn't it make more sense, if you can establish your case, to have a permanent \$5 billion [intermeeting limit] instead of having to come to the Committee each time?

MR. STERNLIGHT. Well, this was reviewed--I forget when--and we went to the \$4 billion limit. The Committee has gradually raised this [limit]. When it was reviewed a year or so ago, I think it was raised from \$3 to \$4 billion; the feeling was that with \$4 billion

there were likely to be maybe one to two occasions a year when we would have to come to the Committee [for a higher temporary limit]. I think the Committee's preference then was to set it a point where once or twice a year we did face the limitation and had to come before the Committee rather than to set it so high that it very rarely, if ever, needed review.

MR. BOEHNE. This is typical for this time of year, isn't it?

MR. STERNLIGHT. Fairly typical for this time of year, yes.

CHAIRMAN VOLCKER. Well, we'll come back to that. Are there any other questions on that point or any other point? Operations are all lucid as a spring [unintelligible] flowing out of that swamp.

MR. BALLE. We need some harp and string music here!

VICE CHAIRMAN SOLOMON. You're saying that if by some chance the Congress were to reach the end of the week without raising the debt ceiling, you think the Treasury could get through until early December?

MR. STERNLIGHT. Yes.

VICE CHAIRMAN SOLOMON. Does the Congress know this?

MR. STERNLIGHT. I think they do, yes. The Treasury has a low point in [its cash balances around] the mid-month and [then] they can get through to about the end of the month.

CHAIRMAN VOLCKER. We might discuss this a bit tomorrow; I don't think we should take time now on the debt ceiling. I sent a letter to Mr. Regan telling him what horrible things would happen if they do run out of money now or later. I presume that will be published at some point but we could distribute it. Or did we distribute it, Mr. Axilrod?

MR. AXILROD. I don't think it was distributed generally.

CHAIRMAN VOLCKER. Well, maybe we can distribute it tomorrow morning so people are aware. It has strong operational--

MR. RICE. Any reply?

CHAIRMAN VOLCKER. Not yet. I don't know what happened. I've been out for a couple days; I haven't had a chance to follow up. Any other comments or questions? We need to ratify the transactions. Without objection. We have this proposal on increasing the limit. Without objection, we will approve that. I don't know how I got you out of order, Mr. Cross.

MR. CROSS. [Statement--see Appendix.] I also have a recommendation, Mr. Chairman. All of the Federal Reserve System regular swap arrangements with foreign central banks and the BIS will come up for renewal in December. And I recommend that all the swap arrangements be renewed. We would propose no change in the terms of the agreements except that in the swap arrangement with the Bank of Japan we are discussing a possible change in the interest rate



provision. The change under discussion would provide a more favorable basis for calculating the interest cost in the event of a United States drawing under the Japanese swap arrangement. We still do not have that negotiated with the Japanese but if it comes about in time and we can do it, we would like to introduce that change in the renewed Japanese swap agreement.

VICE CHAIRMAN SOLOMON. What if it came about two months after?

MR. CROSS. We would revise it.

VICE CHAIRMAN SOLOMON. You wouldn't need a new authorization?

MR. CROSS. Well, I would inform the Committee.

MR. PARTEE. Is this to make it more parallel with the other agreements?

MR. CROSS. Yes. There is a difference in the rate we would pay if we should draw on the Japanese arrangement and in the basis on which we calculate our earnings on investments with the Japanese because they were negotiated at two different times. As we looked at them, tracking them over the period of the past several years, one seems to be consistently a bit below the other and we're concerned about that.

CHAIRMAN VOLCKER. This contingency would be if we drew yen and invested--

MR. CROSS. If we drew yen, the interest rate that we would pay on those drawings is based on Japanese rates and would be slightly less favorable to us, we think, if looked at over time, than the rate that we would get on investments.

VICE CHAIRMAN SOLOMON. The drawing rate we pay, Paul, as I understand it, is the bond rate three months before the bond matures whereas the rate we get when we invest is the 3-month rate on an RP. And there is a few basis points difference here to our disadvantage if we were ever to draw on the yen swap arrangement.

MR. WALLICH. Is this a controlled set of rates? Is that the difference?

MR. CROSS. No, they are not. But when we draw we try to work it out so that what we pay is based on a short-term Treasury bill type rate. In Japan they don't have any such thing, so we base it on a longer-term seasoned bond which is maturing but has only a short period to run. That rate, for reasons I can't entirely explain, seems to be consistently a little higher than the so-called Gensaki rate, which is a [rate in the] much more liquid repurchase market. It seems to have rates that are slightly lower and that's the rate we would get on our investments. So, we want to try to bring about a change.

VICE CHAIRMAN SOLOMON. And the Bank of Japan is sympathetic and discussions are going on.

MR. CROSS. The Bank of Japan is sympathetic but it is always a long and tedious process to have to negotiate anything like this with the Finance Ministry, so it has taken time. But we are trying to work it out.

CHAIRMAN VOLCKER. Are there any other comments or questions?

MR. BOEHNE. Maybe this isn't the right time or maybe it is: Does anybody want to comment on the international debt situation?

CHAIRMAN VOLCKER. Maybe we should just leave that for tomorrow in view of the time.

MR. ROBERTS. Just a quick question on Schroeder, Meunchmeyer, [Hengst & Company]: Did they have a lot of foreign exchange positions in the market? Was it a fairly small bank?

MR. CROSS. There were no foreign exchange implications in that problem. It was local.

MR. ROBERTS. Just the bank?

VICE CHAIRMAN SOLOMON. Well, I think the one thing that is worth commenting on--I don't think Sam mentioned it--is that the price of gold was declining during this period of enormous "safe haven" flows. The dollar has basically replaced gold and that has shocked a lot of Europeans and Arabs and a lot of other people. But they basically told them there are all these events--Lebanon, the Caribbean, etc. They would all expect the price of gold to go up instead of going down.

MS. TEETERS. The price of silver has gone down.

MR. PARTEE. A lot more.

CHAIRMAN VOLCKER. You might say a few words about the debt situation tomorrow, Mr. Truman.

MR. KEEHN. I keep reading that there's a large German bank that has some problems and I assume it's not Schroeder. Is there any truth to that?

MR. CROSS. Well, there are a lot of rumors about banks and they are usually denied. The foreign exchange market on Friday was subject to a certain amount of [fluctuation] when we were closed because of alleged problems with respect to German banks. But, again, sometimes they talk about the situation in Luxembourg branches that we're not aware of.

CHAIRMAN VOLCKER. We need to ratify the transactions. Without objection. We have this proposal for authority to renew the swaps with the possibility of one small change. Without objection. We will see you tomorrow at 9:30 a.m.

[Meeting recessed]

November 15, 1983--Morning Session

MR. TRUMAN. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Is there anything you want to add, Mr. Cross?

MR. CROSS. No. I agree with everything Mr. Truman said.

MS. TEETERS. May I ask a question? Have they been able to keep the regional and smaller banks on these loans to the debtors?

MR. CROSS. Well, they generally have, with a certain amount of effort of pulling and clawing. I think the success has been pretty good so far. There are a lot of questions about whether they will be able to bring them along this next go-around, but so far it has worked reasonably well.

VICE CHAIRMAN SOLOMON. I don't know of any small bank that has refused to reschedule, as distinct from coming up with new money. At least I haven't heard of any lawsuits, attempted lawsuits, or attempted cash-ins, and I find that comforting.

MR. CROSS. The expectation is that this time it will be more difficult. On the other hand, there is greater recognition of the depth and pervasiveness of these problems. I think that the banks also are more aware of the situation and probably have less, or not much, chance of doing anything but going along.

MR. TRUMAN. There were dissents on the other side of the [unintelligible]. I think they are realizing that this is not a short-term problem, and that leads to increasing concerns among the more thoughtful banks. I think, in terms of considering how it will work out over a medium-term rather than a more short-term set of operations.

VICE CHAIRMAN SOLOMON. I think a major problem still is the likelihood that some major debtor country will ask for better terms. Argentina is discussed frequently on the front pages, even though that is the more moderate of the candidates [unintelligible]. I still think that [such a development] is more likely than not. There are various ways in which that request could come forward. Hopefully, it would be in private and in a moderate form and not be accompanied by any threats of a standstill. How the banks will respond to that is still a big question mark, if that does occur.

MR. ROBERTS. Has any consideration been given to changing the nonperforming loan classifications that might develop at year-end if there were major failures to pay interest?

CHAIRMAN VOLCKER. Well, we hope that Brazil will get its interest arrears up to date by the end of the year. Can they or can't they if this [loan] goes through?

MR. TRUMAN. Yes, they can.

MR. CROSS. They can do it if things go as we are hoping they will go.

CHAIRMAN VOLCKER. In that case, the question wouldn't arise in any important way. There is a lot of accounting controversy and discussion and all the rest as to how these [items] are reported. The SEC wants some reporting of them as troubled reschedules, or whatever they call them. There will be more disclosure at the end of the year but they won't go into a nonperforming category, I don't think.

MR. PARTEE. Well, if they are more than 90 days past due, I think they are statutory bad debts and they have to be [so reported]. The accountants would certainly be negligent not to require that they be counted as nonperforming.

MR. ROBERTS. There are reversals of interest accruals also.

MR. PARTEE. I guess that's right, if they are past 90 days. I don't know that anybody is [past due] 90 days.

CHAIRMAN VOLCKER. Argentina will be, I guess, if they don't make some payments. Brazil is more than 90 days, but that presumably will be cleared up first.

MR. TRUMAN. There's a reasonable chance that in Argentina's case there will be enough disbursements so that interest will be current on the public sector debt through the end of September, which would obviate, for the moment, the 90 days requirement.

MR. ROBERTS. What is the latest on the IMF bill? Is that likely to be approved soon?

CHAIRMAN VOLCKER. Well, we only have a few days [before we know] whether it's going to be approved or not going to be approved. There's great negotiation going on; it got tied up with the housing bill and, in a satisfactory way, from the standpoint of the Democrats. That obstacle seems to be removed but there are still a lot of questions. They have to get the appropriation as well as the authorization and it hasn't been through the Appropriations Committee. They are going to try to short-circuit that; whether they can isn't a hundred percent clear. But that is being negotiated right now and has been for the past week.

VICE CHAIRMAN SOLOMON. They still haven't reached an agreement on the [unintelligible] side on the communist countries?

CHAIRMAN VOLCKER. Well, I don't know; in the Congress it varies from day to day. They were not going to have the communist countries; there's still some controversy about the apartheid.

MR. TRUMAN. I think there may be a consensus but not an agreement.

MR. KEEHN. What about the reserve issues? I remember there is a difference between the Senate bill and the House bill.

CHAIRMAN VOLCKER. Those things have all been fixed up satisfactorily, I think. But there probably will be some reserving, not for these big countries, in accordance with proposals that we gave Congress when it was before the Senate. When the loan is in protracted difficulty or whatever we called it, there would be some

mandatory write-off on reserves. This would be for Zaire, Sudan, Poland, and some Latin American countries.

MR. TRUMAN. Bolivia.

CHAIRMAN VOLCKER. What is being worked out now and will probably happen in the next week or so is that some directive will go out. The amount is not massive in total; it would be a maximum of \$300 and some odd million dollars for all the banks together, less anything they have already written off, which is a very foggy notion. But it's enough potentially, if they haven't already written some off, to have an impact on some of the bigger banks in reducing their earnings in the fourth quarter. In terms of the psychology, it will raise the question: If it's Sudan, Poland, and Zaire now, when does Mexico follow and when will Brazil come down the pike and so forth?

VICE CHAIRMAN SOLOMON. But you agreed to create a fourth category in between weak and substandard, I gather.

CHAIRMAN VOLCKER. Yes, but that's different. This is at the opposite extreme where these [loans] are really weak. We will rename those categories so we will have a category that some of these Latin American countries will fit into where the loans won't require any reserving but will get a notice in something like a special-mention category for foreign loans.

MR. KEEHN. This is action we are taking, as opposed to action that is a part of the IMF legislation?

CHAIRMAN VOLCKER. Well, it's consistent with a provision in the IMF legislation. But we would be taking the action a little in advance in a sense. Presumably, the legislation will have passed anyway. It's totally consistent with the Senate version of the IMF legislation but it raises some questions of precedent. It will be the first time we have done it and will raise those kinds of questions. It won't apply to any of these countries that are in negotiation with the IMF or have IMF programs and so forth, but I think it will send a little tremor through the banks.

VICE CHAIRMAN SOLOMON. Some of the foreign central banks and banking commissions are beginning to require a provisioning against [loans to] Latin American countries. [Unintelligible] for this year are requiring 5 percent of the exposure for the first time and they are talking about 5 to 10 percent next year.

CHAIRMAN VOLCKER. Well, this question will arise. Some work also is being done on proposals that we came up with at the time of that [unintelligible] and rejected for the time being--whether to require a reserve against the aggregation of all this if it's too big.

MR. WALLICH. It is reported that the German banks have written off enough in Latin America so that they would be amenable to one of these solutions where the interest rate is lower and the principal is funded into a long-term security.

CHAIRMAN VOLCKER. It's very hard to know what this reserving is for our banks or other banks. They say they reserve. The question is whether they are increasing their total reserves more than they

otherwise would or are saying within some total they have anyway that they are allocating this to Brazil, Mexico, or whatever. I don't think anybody knows the answer to it completely.

MR. PARTEE. In our case, Paul, I think we ought to recognize that that will be a segregated reserve and will not be counted as capital. For these \$300 million--

CHAIRMAN VOLCKER. Or they will write them off. I think many of them will just prefer to write them off for their [unintelligible] balance sheet. I say write them off; it's just a partial write-off.

VICE CHAIRMAN SOLOMON. Some of the banks' CEOs said to me that they would be most reluctant to start provisioning if the reserves were [not] tax deductible; they are concerned that the IRS regs would not--

CHAIRMAN VOLCKER. Well, it's a foggy area. This write-off equivalent is what we would be [unintelligible].

MR. PARTEE. It's mandated.

VICE CHAIRMAN SOLOMON. They don't want the write-off equivalent. And you're saying that the specific reserve provisioning would be deductible?

CHAIRMAN VOLCKER. Only this particular type of specific reserves. Our banks are very reluctant to write off or reserve in a way that really adds to the reserves. It has been argued so many times that we can't do enough to make any difference, and it just raises questions about the loans. Our banks operate more in a goldfish bowl than any of these other banks who can write off without telling anybody their reserve [unintelligible] and they haven't got any hidden reserves. The allegation by many of our banks is that they are reserving whereas these other banks are not really reserving. They just move something out of hidden reserves into calculated reserves.

VICE CHAIRMAN SOLOMON. And the argument against write-offs is that the debtor countries become aware of it and would have less interest in trying to keep paying. I'm not sure whether that is an honest point or not.

CHAIRMAN VOLCKER. Some of them have written off some of these extreme ones.

VICE CHAIRMAN SOLOMON. I don't know. [Unintelligible] trying to differentiate between those that have been charged off or written off and those that haven't. So, I'm not sure at all that there is that much validity to the argument that one reason they can't write them off is to take advantage of the tax cut [unintelligible].

CHAIRMAN VOLCKER. I have an ideological question for some of your New York banks who refuse to accept [unintelligible].

VICE CHAIRMAN SOLOMON. Privately [unintelligible].

MR. MARTIN. Ted, what happened to the negotiations or alleged negotiations with the Mexican private sector credits-- exploring the notion of a rollover that would be part debt and part equity. Was that just talk?

MR. TRUMAN. There have been some of those, I think, in the big conglomerate cases. I don't know how widespread it is; I think it's fairly limited.

MR. MARTIN. But if it were rolled over into part debt/part equity, would the accounting or the reserving or the nonperforming status be affected at all?

CHAIRMAN VOLCKER. Yes. But the accounting on those private sector loans is easier to handle. They just fall into the normal rule more easily than a sovereign credit. So, they would be handled just like domestic credit.

VICE CHAIRMAN SOLOMON. We still don't have a definitive clarification from the Comptroller on the legal limit being exceeded and how that is to be treated when everything gets rolled over.

MR. BRADFIELD. The staff is still working on it; there hasn't been any definitive clarification. In fact, the Comptroller's staff and our staff are meeting today to discuss it further.

CHAIRMAN VOLCKER. Any better feel on how many banks are involved in that now?

MR. BRADFIELD. From the data that are coming in so far, it doesn't look like a serious problem. There are individual banks that have problems. I don't think it is more widespread than we thought earlier.

CHAIRMAN VOLCKER. I thought earlier it was less than a dozen banks but I fear it is more.

VICE CHAIRMAN SOLOMON. But the thing I didn't understand is that, in my naive mind, it looks like an evasion. Bank of America has said that they would exceed the limit so, therefore, they are going to make the loan from their holding corporation and not from the bank.

CHAIRMAN VOLCKER. That's a possible way of doing it.

MR. CROSS. That's one way around it.

MR. PARTEE. The lending limit is on the bank.

VICE CHAIRMAN SOLOMON. Does that meet the spirit [of the law]?

MR. ROBERTS. It doesn't diversify for the stockholders of the holding company, but it meets the statutes of lending limits for the banks.

CHAIRMAN VOLCKER. We're not probing too closely. It meets the technical [requirements]. In terms of the Mexican [situation] and the interest rates, that is in my judgment the opportunity for the

banks to provide a lower spread--a positive spread, but a much lower one. They stuck Mexico last year. And we will have a provision in the legislation that gives strong moral endorsement at the very least on the part of the United States--it's a Congressional directive--to look for lower interest rate spreads on these.

MR. MARTIN. It's a bit of price-fixing by the Congress.

MR. RICE. It looks that way.

CHAIRMAN VOLCKER. Well, the language, I guess, is all right now. I don't think it's so bad to have a little moral suasion coming out of the Congress. We didn't want it so mandatory that it would foul things up. Mr. Truman and Mr. Bradfield have [determined it is] satisfactory, I hope. I haven't looked at it closely.

MR. TRUMAN. Mr. Bradfield still thinks it can be improved. He believes in this [unintelligible].

CHAIRMAN VOLCKER. Mr. Kichline.

MR. KICHLINE. [Statement--see Appendix.]

MR. RICE. Mr. Chairman, I think the staff forecast is about right, but it's a little cautious on the current quarter. The current quarter seems to me possibly a little stronger than is forecast. I think the economy is slowing down from the third quarter, but not as much as [the staff projects]. I'm particularly impressed with the labor market numbers. There has been some decline in industrial production over this month from last month. But all the other numbers seem to show continued strength at roughly the same momentum as in the last quarter. I wouldn't be at all surprised to see this quarter turn out closer to a 7 percent real rate of growth than the 6-1/4 to 6-1/2 percent that has been forecast. So, I would say the forecast for this quarter is a cautious one. Again, I think the longer-run forecast for 1984 is about right. The main difference that I would see is that the strength of consumer expenditures may continue longer into the early part, or the first half, of next year. And the swing toward inventory accumulation may last longer than is projected, which of course would then mean that the growth rate for the first half of next year would be somewhat higher than is now forecast. I would consider that to be unlikely. But I mention it just to suggest that if there is any error in the forecast, it is that the outcome is likely to be stronger than is now forecast. I was one of those people, I would remind you, who in the spring of this year were concerned about whether the recovery was really as strong as most people thought it was. I'd like to say now that I am convinced and that it's probably stronger than forecast.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Could I ask a question with regard to price changes and the price outlook, Jim? As you know, several of us have had some discussion with regard to futures prices and spot prices and commodity and producer price indexes and so forth. What would be your judgment as to what the spot and futures markets are showing with regard to the first signs of reinflation or the lack thereof?



MR. KICHLINE. I don't think they're showing much. In terms of industrial materials, prices have perked up a little recently. There is still a good deal of weakness in a couple of markets such as copper and I guess silver and lead. What has been changing is that the very rapid run-up in prices in futures markets that we had seen for grains has backed off a bit. In fact, our projection of food prices next year would seem to be high now if you were to take what is going on in the futures markets as a likelihood. So, I don't see a big problem there. We are getting hints in some of the markets of a tightening in supplies, but it's not really dramatic at this moment.

VICE CHAIRMAN SOLOMON. But, Jim, you have the GNP deflator going from 3.5 percent in the third quarter to 4.6 percent this quarter; that's a substantial rise of 1.1 percentage points.

MR. KICHLINE. Yes, I think Mr. Truman is doing that to us. We tried to offset him; I must say I worked very hard but failed. It has to do with oil imports and oil prices and the screwy way in which they enter the deflator.

MR. TRUMAN. Which I'm not responsible for! I'm only responsible for the raw material!

MR. KICHLINE. Apparently it is the mix of commodities that affects this, particularly on the imports side--the oil imports. That may not be clear.

CHAIRMAN VOLCKER. Does that mean that oil import prices are going down?

MR. TRUMAN. They were up in the third quarter and the mix was high. They are going down and, therefore, we get a larger deflator--more negative.

MR. KICHLINE. They are subtracted out and it works the other way in the initial quarter.

CHAIRMAN VOLCKER. Mr. Wallace.

MR. WALLACE. Jim, the retained earnings of corporations have apparently been an important factor recently in holding down the rise in interest rates. I notice in the flow-of-funds tables that this has changed or is changing in the second half of '83. Has that changed or has the financing gap become positive at this point?

MR. KICHLINE. Well, it is in the process of change. It's very clear. In fact, we have raised our projected external needs for funds in the corporate sector especially in 1984 because we've raised our forecast of business fixed investment. Unfortunately, I have a flow-of-funds table here that has about 50 pages and a million numbers and I can't find the line I'm looking for.

MR. WALLACE. I was looking at line 6 on the highlights in table 1.

MR. PARTEE. You have a positive financing gap of \$8 billion in the second half of '83, according to Monday's [staff] presentation.

MR. KICHLINE. The negative that we have in this forecast in the financing gap, as noted, ran through the first three quarters of the year, and we have a financing gap of around \$17 billion in the fourth quarter. So, our expectation is that this quarter will be the first one where the financing gap has swung from a negative to a positive and it rises further throughout 1984.

CHAIRMAN VOLCKER. I'd like to make a modest request that occurred to me earlier. These flow-of-funds figures are always shown in half-year terms. Could you put them in quarterly terms for the period?

MR. KICHLINE. Yes, as long as you recognize the volatility and the substantial revisions in those numbers that half-year patterns--

CHAIRMAN VOLCKER. You like this volatility submerged!

MR. KICHLINE. If you want the full display, we can certainly do that.

CHAIRMAN VOLCKER. If nobody else is going to comment at the moment, let me ask you a question, Mr. Kichline. Mr. Rice said he thought, if anything, that the forecast may be on the low side. Suppose we want to explore the opposite. I'm not saying you would forecast it, but what plausible scenario could you make for substantially more weakness in the first and second quarters than you have projected? What would you expect to see happen if the economy gets weak?

MR. KICHLINE. Well, we'll put Mr. Truman on the spot. I think one of the areas of potential weakness is on the foreign side. Obviously, as the dollar continues to be very high, it raises questions about performance on the foreign side. That's one area of [potential] weakness. Another may well be in residential construction activity. We've seen fluky numbers there--shooting up in August and dropping back in September. Our view is that that's about the bottom, but that's not necessarily clear. It could easily go a bit weaker. Another is this dramatic increase in business fixed investment, which has shown up in terms of orders and shipments in the durable equipment area. And we've had a lot of gyrations on the building side in nonresidential construction. There were deep declines in commercial construction in the spring and then big increases in the summer, and it's hard to read those numbers. It may well be that there's not as much happening on the structure side of business fixed investment, and that would turn our forecast weaker. I would note particularly that we continue to get very bearish reports in office construction; the numbers are still quite weak. We have built in here a flattening out of that--very little growth next year. But it may well be, given the dramatic increase in vacancy rates in many areas across the country, that office building construction is winding down and will go more deeply negative. So, in the investment area and in residential structures and the foreign sector I think there are potential negatives.

MR. PARTEE. May I just note, Jim, that you have brought the saving rate back now, but it's still not a high saving rate.

MR. KICHLINE. No, that's right. It's in the 5 percent area which, as you know, is very low. And we have perceived that to be a constraint on consumer spending next year.

MR. PARTEE. To hold that up?

MR. KICHLINE. Yes.

MS. TEETERS. You have assumed that interest rates are going to stay where they are now, is that right?

MR. KICHLINE. Well, they're a few basis points higher; they are a little higher than the forecast we had used last time, but it's a quarter of a point or so--nothing dramatic.

MS. TEETERS. One of your contingencies is not rising interest rates?

MR. KICHLINE. You mean in the fourth and first quarters--in my answer to the Chairman?

MS. TEETERS. Yes.

MR. KICHLINE. No, I didn't sprinkle that in. If you were to talk about a significant rise in rates, which we have not built into this forecast, again, it seems to me that certainly the residential structures area could be hit early on. But it would have to be much more than we have built into the forecast to alter the picture in the very near term. I think it would have a longer-run implication.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. I just have a comment on capital goods, particularly for those industries or those companies in the Middle West. While there has been some improvement, I think, nonetheless in a broader perspective many of these industries are still doing very, very poorly. We took a look at four components of the industrial production index--farm equipment, construction equipment, metal works, and railroad equipment--all of which are terribly important in the Middle West. We compared their current levels of operations with the third quarter of 1981, which was for many of them a high point. And these four individual sectors are still operating at a very, very depressed level. I'm sure they will come along, as Jim is suggesting, but I also think some of them have undergone some pretty important structural changes. They are still operating at very low levels and the people running these companies continue to be quite depressed about the outlook. So, if there's any error at all, in my judgment it certainly is in that area on that side.

CHAIRMAN VOLCKER. The four you mentioned were what?

MR. KEEHN. Farm equipment, construction equipment, metal working, and railroad equipment. Railroad equipment, for example, is currently operating at 81 percent under where it was in the third quarter of 1981. It has some very individualistic circumstances, which caused that, but it's an industry that is--

CHAIRMAN VOLCKER. An 81 percent decline from 1981?

MR. PARTEE. Yes. That's freight cars.

MR. KEEHN. They are going to deliver about 5,000 freight cars this year, and it's an industry that has frequently delivered, say, 80,000 in a year; and that has been as high as 120,000 in a year.

MR. KICHLINE. In the index, I might note, I'm told there was a dramatic increase in October. The numbers were just released; it's up about 50 percent or something like that. The index level goes from 13 to 19 or something like that. It was 100 in 1967, so it's operating at 87 percent below where it was in 1967.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. I'd like to ask whether, in terms of our capacity limitations, the labor supply limitation is more or less severe in your judgment than the capacity utilization. As I look at the numbers here, you forecast that by the end of 1984 we will get to 82.5 percent capacity utilization, which I would regard as close to the flash point, even though that's hard to define. And at that time we get to 8 percent unemployment, which is still well above a reasonable range for the noninflationary rate or non-accelerating inflation rate of unemployment. Does that mean that we have a tighter capacity ceiling over us than a labor supply ceiling?

MR. KICHLINE. Well, that's a very murky area, as you know. Our concern at the moment runs in the direction that capacity utilization appears to be rising more rapidly, given growth in the economy, than it did in previous cycles. But there are some factors that clearly could affect that. One is that we apparently do have substantial additions [being made] to business equipment at the moment, which would presumably add something to capacity growth. We're uncertain about how to measure recent capacity growth and, indeed, some of the facilities that were removed from the capital stock or allegedly closed down may come back on stream depending on what happens to the economy. So, it may be that the numbers [projected for] a year from now or two years from now are not as tight as they look. But for now I would very much agree that it appears that the risk is on the side of capital shortages rather than labor shortages.

MR. MARTIN. Jim, wouldn't you add the question of world capacity and the business relationships that have been entered into by American firms with foreign suppliers over this last four-year period? Obviously, you have built into the forecast changes in the exchange rate, but I think the business relationships, contracts, and so forth to some extent transcend the exchange rate question. If you talked to some of Silas' constituents and some of the others, they say they are going to continue to use those foreign sources. Now, that's too flat a statement, but isn't that--

MR. KICHLINE. No, I should have mentioned that. That clearly is very important in our thinking about all of this and about the price pressures that might stem from rising capacity utilization. I would say that it's particularly important in the context of a very sluggish current and prospective recovery abroad. So, there appears to be in many key areas ample world-wide capacity.

MR. MARTIN. Let me ask a second question with regard to labor resources. If your productivity figure is indeed too low--as I have said innumerable times that I think it is--where does that leave you with regard to unemployment rates?

MR. KICHLINE. Well, I think in the shorter run we will probably be talking about higher unemployment rates. It's conceivable that in the short run it means that businesses would not be adding as much to payrolls as we have projected in this current forecast. So, we would expect that to give us perhaps a bit higher unemployment rate in the shorter-run context--that is, the demands for labor would be weaker.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, the conditions in the Sixth District are substantially different from those reported by Si Keehn. In practically every sector, with very few exceptions, we're seeing very, very robust growth in the economy--August auto sales, retail sales, housing construction, and so on, and even areas that have been badly hit by the recession and were giving us very gloomy reports until recently. Alabama, Louisiana--particularly due to the energy sector--and Mississippi are reporting substantial gains in their situations. Even the areas that I mention as exceptions--housing and agriculture--are doing better. The farmers, of course, were hit by the drought and the excessive heat during the summer. But the PIK program has insulated a lot of them from difficulties, and their revenue will probably be up. When you put all of this together, as far as the Sixth District is concerned, we see very, very robust growth ahead for the rest of '83 and for '84.

I don't have any particular quarrel with the staff's analysis but like Governor Rice I would think that the strength of the economy, if anything, is being underestimated, especially for the fourth quarter. So, we would be looking for higher rates of growth in the fourth quarter and probably in '84. Associated with that, I would say, too, that we think the staff's inflation forecast for '84 is perhaps a little on the low side.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. The situation in the Ninth District is a lot like what Bob Forrestal has just described in the Atlanta District. The reports that we're getting are of strength across the board, even in some of the areas that have been very weak, such as iron ore and so on. It's not booming yet but the mere fact that one of the big taconite companies has just announced that they're recalling 1600 workers as of January 1st, in the context of the situation up there, is quite a dramatic development. The lumber and timber areas are very, very strong. There is even a renewed surge of activity--I don't want to call it a burst yet--in the oil and gas producing areas in western North Dakota and Montana. The number of operational rigs in the field has doubled--from admittedly a low level--in the last couple of months. The farm price situation as it was reported to me is probably compatible with what Jim said earlier; in a sense it's looking better. If anything, our people are suggesting that they think it looks even a little better than Jim says. One of the things that is now being cited is that the change in the dairy and milk

program that was enacted by Congress last week in all likelihood is going to put a lot of milking cows into the slaughter market and that will work to hold down the widely expected big jump in beef prices next year. So, by and large, our agriculture price outlook is thought to be improving, if anything.

In the Twin Cities area, the character of the situation, I think, really has changed. For example, we even heard reports last week of strengthening in office space rentals in a context in which there's a tremendous amount of new building going on in the Twin Cities. And last of all, in terms of an anecdotal leading indicator, I've been struck myself just noticing the number of help wanted signs in the store windows of small businesses throughout the Twin City area. That is something that I certainly can't recall seeing since I've been up in those parts of the woods. On the housing side, though I don't know to what extent this is generalized, I get the sense that the housing market is being held up by the increased acceptance of variable rate mortgages on which the initial rate, the rate that people are looking at today, is a relatively moderate rate compared to the rate on conventional fixed-rate mortgages. To what extent that will last is another thing. But right now I think it is one of the things helping to hold up the residential side.

I also think, as I have for some time now, that the risks are on the up side in terms of the economy and clearly on the up side in terms of inflation. I've looked very hard to find any hard evidence of a resurgence of price pressures and can't really find it. But I must say I have the distinct sense, extracting from the numbers, that it's either there or lurking close at hand. Certainly, we do get a lot of reports of disappearing discounts--in some cases substantial discounts off posted prices for industrial goods--which may or may not be captured in the price statistics. And, getting back to the discussion of yesterday, I think the character or the chemistry of the recovery as it pertains to the interaction of wages, productivity, unit labor costs, and cash flow to the business sector--any way you look at it--clearly is about to change. Even if productivity is stronger than the Board staff's forecast, we still are going to have a marked shift away from the phenomenon of the last few quarters in which wages were decelerating, productivity was growing very sharply, and unit labor costs were actually declining for two quarters running. So, even if productivity is stronger than the staff estimates, which I think it will be, I still think that the character of the recovery as it pertains to cost-price pressures is about to change. And that is one of the reasons why I think it's going to be very, very difficult to hold the inflation rate in the 4 to 4-1/2 percent range.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. With regard to the economic outlook in the Fourth Federal Reserve District, I thought I would come at it from the side of some of the industrial developments in the District and what they might mean for the near-term outlook for inflation. It has been said many times around this table, and I just repeat it, that the labor concessions that we've seen have been in industries that are under severe market pressure and are fighting for survival. Of course, the question remains: How long-lasting will those concessions be in industries that pick up? They may, of course, continue in those industries that are getting smaller over the long term.

Let me make some specific industrial comments. First, about autos and the nationwide Chrysler settlement that had been followed by the local settlements: All the locals settled except Twinsburg, Ohio, which is the metal stamping plant for Chrysler, and Twinsburg went out on strike. The settlement of that local agreement was considered a union victory to be settled regardless of cost to the company, which in lost earnings was somewhere between \$50 and \$100 million. I think there are reasons to argue that that is overstated and that Twinsburg was unique. There had been a terrible industrial accident there in which a man was crushed to death in a stamping machine. The working conditions are bad in metal stamping plants and that is an old stamping plant. In addition, it had a rather unique situation in having quite radical union leadership at that plant. Nonetheless, I think what happened at the Twinsburg Plant is indicative of workers' attitudes and it is one of the things that makes me apprehensive about the upcoming auto negotiations. It makes me think, as we look at those negotiations next year, that maybe a number like 6 percent is on the low side of what might come out of those negotiations in an industry that has been quite profitable. In thinking how auto negotiations might affect inflationary expectations and inflation through the economy, one can look at other sectors of the economy where there is some strength and talk about those being the next to go. One strong area that we see, of course, is trucking. That might be the dynamics by which inflationary expectations build.

Let me turn to another industry that's heavily represented in the Fourth Federal Reserve District, which is steel. That brings questions of both capacity and productivity. Capacity has been discussed, of course, and capacity growth rates have been slowing domestically in a number of our industries, and in some industries we've even had liquidations. This brings forth a great question of how we measure capacity and when the cost pressures will show through into prices, as has been discussed. Steel causes me to see the productivity outlook as mixed. On the positive side, I agree with a number of comments that have been made to the effect that if you talk to businessmen, they think that they not only have accomplished significant increases in productivity but they see ways that they will continue to increase productivity in the future. On the negative side, if you look at some of our beleaguered industries in the Fourth District and talk about labor attitudes toward productivity, it's very difficult to convince organized labor that productivity increases are important. We tell them [they are]. I think they believe quality increases are important--that they are not competitive because their product is shoddy compared with a foreign import. But I think they see productivity increases as a way to lose jobs. It's like the old story about when oil prices were going up and people were supposed to use less electricity, and they paid more for their electricity. It's the short-run effect. It is very hard to convince labor of the importance of productivity increases, particularly in industries facing severe international competition. To go back to the Twinsburg situation, in the context of productivity, I think almost the most important thing that came out of Twinsburg was probably the re-evaluation of the way of doing business that we thought was going to happen in the auto industry. It still may, but I think they are very carefully looking at something like a just-in-time concept of producing products because they found out that if they don't have the same kind of labor market conditions as they have in Japan, an inventory control method like just-in-time can shut down their

business. And at least at Chrysler they are really evaluating their possibilities.

MR. PARTEE. That might lead to larger inventories?

MS. HORN. Yes--not labor productivity but capital management productivity, that's for sure. I think that's a very serious outcome.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Well, I'm getting worried about whether or not we're going to get the speed and the degree of slowdown that the staff has forecast. I agree with Governor Rice that the current quarter is one in which we may end up with more GNP growth than 6.3 percent. I wouldn't worry too much about that, but I would worry a lot if growth in 1984 didn't slow down to somewhere close to the 4-1/2 percent or so rate the staff is forecasting. One can make a strong argument, based on past cyclical performance, that we're going to get a lot less thrust from those two areas that typically lead the recovery--housing and inventories. What we don't know at this point is the degree of strength that is developing in the business fixed investment area, which tends to replace the strength that comes along from housing and inventories in the first year of recovery. We're in a very difficult position, I think, in trying to predict that because the investment intentions surveys that we used to depend on so heavily have become almost totally worthless. The two private surveys we have gotten now for 1984 are predicting increases in nominal terms of between 9-1/2 and 11 percent. And the staff has said, quite properly, that those numbers can't possibly be right; a lot more has happened. The other kinds of information that we've tended to use are the contracts and orders figures, and they show simply enormous strength. The contracts and orders figures in September in real terms are up at a 25 percent annual rate [from] the fourth quarter of 1982. The problem with forecasting from those figures is that they carry for about a quarter or maybe two quarters but not much further. The staff's forecast for business fixed investment is reasonably strong for next year but it shows a progressive slowdown in the rates of increase from what we've had recently--from a 15 percent annual rate in third quarter of 1983 to 13 to 11 to basically 9 percent. And if that doesn't happen and we get something more toward the upward end--in the 10 to 15 percent range--then we have a lot more growth ahead of us than we've allowed for.

The other reason I think we ought to ask ourselves whether past cyclical patterns of slowdown in the second year are going to emerge is the policy assumption the staff is using on the monetary side. It is true that we've had a very, very substantial slowdown in the growth of the monetary aggregates, but we've also had a very substantial turnaround in the performance of velocity. The staff here--and there are many other economists who have been doing the same thing--have been using what we call effective money growth or what other economists call adjusted money growth. I have been looking at some of the numbers. What you do is ask yourself what would have happened to the money stock if the relationship between money and GNP and interest rates had been what it was prior to 1974. Now, that's a wild kind of thing to have to do, but it yields some interesting results. What it says is that effective money growth in the first three quarters of this year was about 6-3/4 to 7 percent at an annual



rate, about 5 percentage points below the actual figures. And in the fourth quarter it's going to be reversed; it's going to be about 8-1/2 percent at an annual rate, about 5 percentage points [above] the growth forecast by the staff. Next year the staff forecast assumes that 7 percent is appropriate; but if we translate that to effective money growth, it comes out to 8 percent. And that means, if you believe the staff's forecast for real money growth, that M1 is increasing at a 3-1/2 percent annual rate next year. That is very, very high by historical standards. On the fiscal side, I would remind you that we still have a lot of fiscal spending ahead of us. The full employment deficit, based on the 6 percent unemployment rate calculation, went from a \$10 to \$15 billion range in the first half of 1981 to a \$65 to \$70 billion range in the first half of 1983. It goes up to a range of \$115 to \$120 billion in the first half of 1984 and to \$125 to \$130 billion in the last half of next year. I have to figure, with that kind of fiscal stimulus and monetary expansion still proceeding quite rapidly, that the chances of an overrun of the staff's forecast for next year are very substantial.

CHAIRMAN VOLCKER. Mr. Wallace.

MR. WALLACE. Mr. Chairman, I could echo the kind of bullish report that you heard from Bob Forrestal and Jerry Corrigan as far as our District is concerned. Of course, I'm talking primarily about the state of Texas; the recovery is very much in evidence there. It was fueled initially by the construction industry, which remains a strong element of that recovery, at least on the commercial construction side. I think residential construction has plateaued at this point but now we're seeing strength developing more generally from the industrial side of the economy. That is in evidence in such industries as aluminum, copper, and steel; and although the evidence in the high-tech electronics industries is spotty, that is still a source of strength. And we're beginning now to see some evidence of recovery in the energy sector though, of course, it's also not as much as in the District economy generally. But we are seeing evidence in the variables we tend to look at such as the active rig counts, which have shown a 23 percent increase since July, and the seismic crew counts in the District, which have increased 20 percent since September. This is occurring throughout the four-state region that we look at but, again, primarily in Texas. So, there is evidence of some upturn in activity in that industry. That does not indicate that we will see relief any time soon in the sense that some of the bad loans in regional banks that have been very much in the news recently will necessarily get paid off, but at least over a long period of time it should provide some relief there. The services side of the energy industry is still very much depressed--the mud suppliers, the welders, the truckers and all that goes along with it. That has not shown any evidence of picking up yet. Of course, this is attributable to several things but it's not attributable to any prospect, at least at this point, of higher oil prices. It seems to be resulting from lower production costs and the fact that the economy in general is showing some increased strength. Certainly, the weakest part of our economy at the moment continues to be the border region, which I think we would have to say is still in a state of depression. There has been some improvement in the economy in the El Paso region but not in areas farther down such as Laredo, Brownsville, McAllen, and so on. Those cities are flat on their backs. The city of Laredo at this point has

the distinction of having the highest unemployment among those cities recorded in the labor statistics.

We have noticed some curious activity in certain parts of the District. One of the questions that you raised with us when you were down there last week was about land prices, and we talked with a few people in this area. Some prices of raw land are being bid up on the basis of the prospective development of retail strip shopping centers and that sort of thing. We've uncovered a few instances of land changing hands as often as 3 or 4 times a day in this process, which we hope is not a usual situation, but that was the latest--

MR. PARTEE. It has to be set up in advance.

MR. WALLACE. It could be.

SPEAKER(?) But not in Texas.

MR. WALLACE. For example, there are instances of land as far as 25 miles out from the central business district of Dallas where prices have been bid up to \$5 to \$6 dollars per square foot on the anticipation that these properties will be prime sites for shopping center developments and that kind of thing. That, of course, would be along major highways. One of the members of our staff attributes this to unsophisticated developers being fueled by unsophisticated lenders, primarily in the thrift industry. Unfortunately, this is not a very favorable development. But I think on balance the economy of the Eleventh District is very strong at this point, and I certainly would agree with Jerry Corrigan's comment that the risk is on the up side, and I think we will continue to see increasing inflationary pressures in the months ahead.

CHAIRMAN VOLCKER. Does anybody else see the kind of land speculation that is going on in Texas?

MR. BLACK. You mean land changing hands three times?

CHAIRMAN VOLCKER. Prices are up in some areas four or five or six times.

MR. WALLACE. I don't want to leave you with the impression that this is a common everyday occurrence; on the other hand, I don't know that it's not either.

MR. PARTEE. That's better than \$200,000 an acre!

MR. WALLACE. That's right: \$5 to \$6 dollars a square foot is \$250,000 to \$300,000 an acre.

VICE CHAIRMAN SOLOMON. Well, New York real estate is still [unintelligible]. To the extent that people are looking around for an inflation hedge, the collectibles market has picked up quite rapidly in the last two months; much higher prices are being bid at auction houses. It's almost as though people are thinking in the inflationary hedge terms we saw a couple of years ago. I can't understand why there is such a rapid rise in prices at the better end of the scale.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEES. Well, Mr. Chairman, I continue to be impressed by the differences in the strength of an aggregate like real GNP, which is looking strong, versus the reports I hear around the table and the conditions I witness in our own District industry by industry. Basically we have both great strengths and great weaknesses. Perhaps that is what one expects in a recovery that is less than a year old. Certainly, if you disaggregate the economy, you get a marked impression that things are not going well across the board; some things are going very well indeed and some things aren't going so well. It's only in some aggregate sense that the economy is continuing to move upward. But I'm beginning to get concerned about some of the distortions that are taking place in some key industries, despite overall growth in employment and production--in areas such as construction, trade, finance, services, and so forth. The drop in housing starts that we had last September of some 15 percent is really beginning to feed back into the forest products business now, and the recovery that had taken place in the state of Oregon clearly has stalled. Unemployment is rising again. In our aerospace business, our country's biggest company has continued to reduce its payroll up until very recently. But there is some good news there because they have just gotten a heavy inflow of new orders for commercial aircraft. New orders in the last month or so have been greater than all the rest of 1983 put together and the backlog of unfilled orders is now rising. And that's, of course, good news for the Pacific Northwest.

MR. BLACK. John, are they domestic orders or a combination of domestic and foreign?

MR. BALLEES. It's a combination of domestic and foreign in the commercial field. I'm not talking about the military areas now. The other thing, which is disturbing in the sense of representing some real distortion in the structure of production in the country, is that we have important agricultural economies in the the western region--California, of course, being the country's biggest single agricultural state--and I keep hearing many of our directors sing the blues about what the high value of the dollar is doing to export markets. This ranges all the way from log exports to Japan to cotton exports coming out of the central valley in California to a good part of the rest of the world. So, even though yields on a good many agricultural crops are reaching new records, the markets for these products are lousy and that's a direct reflection of the value of the dollar on the exchange markets. I think we ought to keep these kinds of things in the back of our minds as we assess the outlook, [knowing] that not all of reality gets captured in things like real GNP.

MR. RICE. Doesn't our forecast call for a decline in agricultural output?

MR. KICHLINE. Yes.

MR. RICE. That's somewhat contrary to what John Balles seems to be observing.

MR. BALLEES. It depends on which commodity you're talking about, Governor Rice.

MR. RICE. Agriculture overall.

MR. KICHLINE. I think overall it's a small decline in output, but there really is a bad mix problem in terms of some components rising and others declining substantially.

MR. BALLE. My information, Jim, is that the wheat crops around the whole country will be at a new record level by a big margin and that the foreign demand for it just isn't there and the farmers are very worried about price prospects. Does that jive with what you hear in your District, Roger?

MR. GUFFEY. As a matter of fact the wheat crop has received moisture and looks very good at this point. Lots of things could happen between now and harvest, to be sure. But if it comes forth as a good year, then we could be in trouble again in wheat.

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. In the Eighth District, things are looking good. I would say we've moved from what I previously called reluctant optimism to near euphoria. Sales, which reflect consumer attitudes, are running very strong. The merchants we've talked to in the major cities in the District think we're going to have a very outstanding Christmas season. Automobile sales are good; they are running about 21 percent over a year ago. Unemployment, which has been high, is coming down now very noticeably and the Missouri Division of Employment is predicting substantial reductions beginning in December. A large part of this is due to planned expansions at the area's auto plants. Ford and GM are planning expansions around the first of the year and Chrysler is going to add a second shift of 1,200 workers to one of their assembly plants, number 2. There is an interesting anecdote regarding this workforce expansion--some good news and some bad news, I guess. Chrysler is limiting applications for the jobs to a total of 6,000. They're taking 3,000 applications through their Presswood employment office but they distributed 3,000 interview cards to present employees to give to interested parties. The story going around is that employees are selling these cards for about \$200 a piece, which either indicates that there are still a lot of people who want to be employed who aren't or, if you figure the chances of being hired are about 1 in 5, that the present value of the rents after union dues is \$1,000 per worker at the Chrysler plant. I guess that tells you something about why we don't do well with import competition. GE is adding 1,400 workers to its Louisville appliance plant by mid-January--again, an indication of a tough area that's coming back. Granite City Steel is going to add 1,000 to its workforce, and steel has been a very depressed area. Even residential home sales are looking good. They're below the peaks but still strong and well ahead of a year ago. Construction of new homes is brisk. We have good order backlogs. I hear the builders expressing optimism again after being rather blue a couple of months ago. Residential construction in St. Louis is up 21 percent. Nonresidential construction in September in Missouri was double the September '82 figure. Overall, the nonresidential numbers are looking quite good. So, except for agriculture, where we've had the worst drought in 50 years and where with the PIK program we've had big reductions in yields in corn, soybeans, tobacco, and cotton, I would be with the optimists in terms of the outlook, for the fourth quarter in particular.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I would like to address some of the downside risks with regard to the expansion in order to get that on the record and also some pessimism as to prices. Obviously, our goals are both disinflation and growth. And those of you who have served on the Federal Reserve Board since 1979 deserve all the recognition that you'll never get. But this is not an expansion like that of the 1970s. We don't have the kind of world inflation or the kind of economic growth in the OECD countries or in the less developed countries that we've had in other periods. I wonder if, in a global sense, the problem today isn't the illiquidity of so many financial structures and corporations around the country and the slow growth that characterizes most of the world outside the United States. We've talked about productivity, and certainly that is a positive factor in terms of future inflation. But that should be coupled with the kinds of comments of an anecdotal nature that I have picked up from my business contacts. Certainly, the businessman is going to try to raise his prices. Certainly, the union leadership, particularly the new young faces you see in union halls who have taken over from the old guard, are going to try to make their reputation. But we have not talked much about the natural rate of unemployment and the current rate of unemployment and the projected rate of unemployment since yesterday. That kind of analysis is still before us. The anecdote I hear is: "We're going to try to raise our prices but we're not so sure in terms of world competition that we're going to be as successful in that as we have been in previous recoveries."

This is still a typical recovery. I think we are talking about it here a little in terms of our awe that we have so exceeded our own forecast. But if you look at the 5 or 6 recovery periods since World War II, on an average basis we're talking about 5 percent real growth or so in the first three quarters of a rather typical upswing. [As for] the expectational side of what data we can get--what President Corrigan [mentioned]--I've certainly examined these data. If you look at the commodities, spot and future price indexes, other than what has happened in the past few days, you find if you go back a month or two months that index after index on the spot market--seven or eight of them--is down or pointing in that direction. If you take the futures market, it's not so clear. But of 10 or 11 indices there 7 out of the 10 are pointing downward. The stock markets, once you get beyond the misinformation of the DOW and look at the other market indices, are down; the common stock prices of the NASDAQ and of the AMEX and the general markets are certainly not pointing toward a revival of inflation. It seems to me, then, that looking at the world situation and looking at how we stand vis-a-vis previous recovery periods something can be said for steady-as-you-go rather than using out intuitive feelings about a revival of inflation. Rates, both short and long rates, have already revived some; they have gone up some since the last FOMC meeting. There may be a question that we should keep in mind about 1985 and how we're going to sustain the expansion into 1985 when inflation is still perhaps not as revived as our intuitive sense would say and unemployment is going to be very substantial and the world economy is probably not going to be that recovered.

MR. GUFFEY. Mr. Chairman, I think the Tenth District is sharing the general optimism about the recovery, particularly as it

relates to consumer retail sales. Residential construction has picked up. For commercial construction, on the other hand, it depends on what area of the District one is talking about. The Denver area was in a boom for a number of years and is well overbuilt, and that's not a very vigorous sector. But if you begin to disaggregate the basic industries or areas of economic activity in the Tenth District--if you look at energy, there has been some moderate upturn in the number of rotary rigs actually working. But it is only modest, even though percentage-wise it looks pretty good. It is maybe 40 percent greater than 8 to 10 months ago, but that was a very low base level from which they are working up. Mining, on the other hand, particularly coal, is flat. There is certainly no increased activity in the mining industry. That whole industry hasn't begun to recover yet. Commercial aircraft, which is a very big segment of our economic activity, is flat on its back, contrary to what John has reported about the Northwest. There is no backlog of orders; as a matter of fact there are continuing cancellations of commercial jet aircraft orders. The one bright spot is a military contract landed by the Lear Company down in Wichita and in Arizona, but that's just one blip on the horizon. As for the rest, they are looking at a rather dismal outlook.

With respect to the agricultural sector, you spoke of land prices. As I think most of you around the table know, through this recession agricultural land prices fell somewhere between 15 and 21 or 22 percent, depending upon whether it was dry or irrigated land. And those prices have not yet turned up. As a matter of fact, the report that I've had is that there will be some continuation of foreclosure on farmers and ranchers as a result of their not being able to service their debt. Although there's a good deal of optimism at the moment in the farm area over the PIK program, which has given them a cash flow so that some of them can service their debt, I think the observation is correct that without some improvement in the export market, there isn't a great deal of hope for substantial improvement in the period ahead.

As to unemployment, it has been decreasing; one of the principal reasons is auto assembly, which is a fairly large segment of our economic activity. Auto plants have put people back to work and as a result the unemployment rates have dropped dramatically in Missouri, as has been observed by Ted Roberts, as well as in Oklahoma where there are auto assembly plants. With regard to the mainstream merchant in the agricultural area, it's a mixed bag. In the agricultural chemical area, they have had a very good fall season and look forward to a good spring. On the other hand, for the farm equipment manufacturers there's nothing going on in sales. It's obvious that the ranchers or farmers are just not buying any additional equipment; they are not making any capital expenditures. They're just sitting and waiting to see what will happen. So, in summary, it seems to me that we're enjoying the benefits and the optimism of the consumer but the underlying support in the Tenth District isn't all that great.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Listening to the reports from around the Districts, by and large they certainly do show a change in attitudes as against two or three months ago, probably just because we've moved

to a later stage of the business cycle. We're now clearly in the expansion phase of the business cycle and that's reflecting itself very broadly across the economy. There are structural differences, and I don't think we ought to be misled by them. The policy mix in particular creates different circumstances than in previous recoveries. John is concerned about his agricultural industry and his lumber products, but that's a direct result of the change in policy mix; we have higher interest rates and a higher dollar than we would have otherwise. And the counterpart of it is generalized purchasing power, reflecting more [after] tax [income] that people are earning. That just goes throughout the spectrum and brings us these reports of better retail sales and consumer optimism and so forth; that's just the other side of our picture. So, taking that into account, I don't think there's anything that unusual, after adjusting for the policy [mix] change, in the recovery.

VICE CHAIRMAN SOLOMON. Isn't business fixed investment stronger than one would expect with that policy mix?

MR. PARTEE. The difficulty there is that we don't know how much the tax incentives are. It may be that the tax incentives are offset by the [higher] interest rates in the aggregate. Although I must say, speaking to Governor Gramley's comments, that I'm inclined not to think that there is much strength in the business fixed investment area. I don't think it has that thrust and momentum; and I don't believe it's going to be that strong looking out ahead. On the other hand, I'm impressed by what Karen Horn says about inventories. I've noticed that in the last several months we've had very [sizable] accumulation but the ratio of inventories to sales has not improved at all; it's right at the bottom. And if business should have a view that in order to take advantage of opportunities it needs a little thicker stocks, we could get quite an inventory accumulation, particularly if it should follow a Christmas season with very strong consumption because people feel good this year. Therefore, there may be a little more [upside] hazard in the combined inventory-consumption area for the expansion. But I don't agree that plant and equipment is all that strong. Maybe I'm just too much of a Midwesterner and I'm impressed by the continued weakness in the basic industries which seems to me to be still, as Si says, very, very marked. In sum, I rather agree with Pres Martin that we're having a good expansion. There is some danger that it may run too strong as time goes on, but we don't have any indication of that at this point. And we don't have any indication of a heating up of inflationary pressures. And, therefore, perhaps what we ought to do for the moment is to sit back and enjoy it.

CHAIRMAN VOLCKER. Without any other comments, we'll ask Mr. Axilrod to deliver his remarks.

MR. AXILROD. [Statement--see Appendix.]

CHAIRMAN VOLCKER. You can put a doughnut in your stomachs now!

[Coffee break]

CHAIRMAN VOLCKER. Well, I guess as Mr. Axilrod carefully explained to us, we have somewhat conflicting feelings and signals of

great ebullience and some [concern] about the economy. I just had Mr. Kichline check, and you have to look fairly hard among past recoveries to find three consecutive quarters [of growth] as high as [we have now], including the projection for the fourth quarter. Interestingly enough, 1958 was a bit more rapid and immediately terminated after three rapid quarters.

MS. TEETERS. There was a steel strike.

CHAIRMAN VOLCKER. Maybe it was the steel strike that made it end so abruptly.

MR. MORRIS. The first two quarters of 1981--

CHAIRMAN VOLCKER. I mention that because I think some of these things about the strength of the recovery are a little misleading. We started out with a fairly slow quarter. That's probably an accident of when somebody dates these things or just how it starts out. The recovery really is in my judgment somewhat above average since it has gotten some momentum; it may be quite a lot above average. We have some weakness in M1; I don't think we have too much weakness in the broader aggregates at the moment. That M1 weakness comes against the background of having had a big increase earlier and having raised our target in effect by rebasing it. I'm not sure there are grounds for making any very violent move at this point. But, let's see what other people think.

MS. TEETERS. Mr. Chairman, I just want to bring up one thing that I don't think has been touched on, except in the early discussion this morning. I'm not sure we have an awful lot of room to do very much because of the foreign international debt situation.

CHAIRMAN VOLCKER. In a tightening direction.

MS. TEETERS. In a tightening direction, that's correct. I happen to agree with [the view] that this is a typical recovery at this point; if anything, it's a little stronger than even I predicted a year ago. But I don't see any great need to move it down because it's going along at a very nice clip, though perhaps a little too fast. I don't see that we have any upward mobility at this point, at least until we have some of these things a little more firmly set in the international area. And I think it would be extremely dangerous to make a major move of any sort at this point.

VICE CHAIRMAN SOLOMON. I second it.

MR. KEEHN. Third.

MR. PARTEE. Fourth.

CHAIRMAN VOLCKER. I don't hear any sentiment for a major move now. Maybe we'll do this in a different way. Does anybody want to make a major move?

MR. RICE. I think we have no basis for a major move downward at this time.

VICE CHAIRMAN SOLOMON. Or up.



MR. RICE. Or up.

MR. BOEHNE. It seems to be in the nature of human beings to want to complain a lot when things go poorly and to want to worry a lot when things go well. As I was listening to what was being said around the table I thought that at least central bankers are human: Things are going pretty well, so we'll worry a lot. But I think now and then we ought to have the courage, as Chuck said, to sit back and enjoy it. So, I'd fifth or sixth or whatever [the motion] and leave well enough alone.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. Well, I guess I'll take on the role of the school of contrary thinking for about the third month in a row, just so we don't get too complacent. What I'm referring to, Mr. Chairman, is the move we made--with which I agreed at the time and which we all know about--to deemphasize M1 and to pay more attention to the broader aggregates. There was good reason for doing that. We also said to ourselves, I think [the record] will show, that when and if M1 began to behave more normally again, particularly in terms of velocity, we would reconsider whether more emphasis ought to be put on it. A couple of months ago--specifically in August--I circulated a paper that had a couple of key conclusions. One was that the broader aggregates, M2 and M3, looked to us to be highly unreliable as a forecaster of income, prices, or anything else for the last couple of years. M1 admittedly wasn't perfect but it was a lot better than the alternatives had been in the past, and I expect it will be again in the future once we get a revival of velocity looking somewhat normal. We were forecasting in our Bank at least that that would happen by the closing months of this year, and that forecast looks better than ever now. It is pretty much expected--I see similar figures in the Bluebook--that we will have a strong rise in velocity of M1 in the fourth quarter. And for that reason I'm again suggesting that we not wait too much longer before putting M1 back as one of the primary intermediate targets, along the lines it used to be, simply because I have such a big distrust of M2 and M3 telling us anything.

We went through a big recession and now have a strong recovery, and we hardly would have noticed it from what happened in the behavior of those broader aggregates. I recognize your point, Mr. Chairman, that the recent slowdown in M1 has to be viewed against the background of the strong growth earlier and the fact that we did rebase in July. Having said that, I'm not sure I'd be comfortable with seeing another month or two of very low growth in M1 just because it seems to be coming back on track in terms of behavior, including velocity behavior now. Our San Francisco money market model would not suggest any major move and I too am against a major move in policy at this time. But I would suggest a modest move toward nudging that funds rate down at least 50 basis points in order to get a little stronger M1 growth in the remaining months of this year and bring it by December at least a little closer to the midpoint--though it would still be under the midpoint--of that 5 to 9 percent range. Frankly, I'm skeptical about whether we're going to get the 7-1/2 percent growth in November-December mentioned in the Bluebook, given the recent level of the federal funds rate. So, in a word, I would be in favor of moving toward the specifications of alternative A in order to accomplish what I just outlined.

CHAIRMAN VOLCKER. Let me just comment that I think it is possible that more predictable relationships may be returning to M1 but, speaking for myself, it's a little too early [to be sure]. I think we probably are going to have a very big increase in velocity here, which will make up for some of the reverses earlier, but what the trend is going to be in the future isn't clear. I wouldn't assume that this increase in velocity is going to continue. But whether it will lapse back [unintelligible]. But, given the burst that we had earlier and now the retracing of it, partially anyway, at what point does one assume that [a return to normalcy] begins? It still mystifies me.

MR. PARTEE. John, I think technically that's a reasonable proposal. But I must say that you're making an awful lot of small differences in M1 growth. The projection is for pretty good growth. If it doesn't occur, of course, then we have a situation that needs to be confronted. But the projection is 7-1/2 percent [for November-to-December] and 5-1/2 percent for the September-to-December period. And it seems sort of strange to be reducing interest rates significantly with the background of the economic discussion that we had before the coffee break. It almost requires, it seems to me, a confidence in the technical relationships that exceeds what I'm able to have in them. So, I just can't agree with your particular proposal, but I do agree with your general comment that M1 is a lot better than it has been cracked up to be and quite a bit better than M2 and M3. And we ought to review this in connection with the posture we take for next year, which I guess would be at the next meeting and the January meeting.

MR. BALLE. Well, that's right, Chuck. I didn't expect to change many minds today, but one of the reasons I wanted to raise this flag of caution here is that, as I look back at the 11 years I've been sitting around this table, I think the mistakes that we've made have been ones of intuitively trying to look through the intermediate targets to the economy as a whole, while officially we never did, if you wish, target real GNP and even interest rates. That has led us more often than not into a pro-cyclical monetary policy. And it was one of the reasons that the Chairman proposed to this group in October of 1979 that we get off our interest rate stabilization in the short run and onto monetary targeting. I think what we really have been doing in the past year de facto is targeting interest rates, and I'm afraid that again that will lead us to some pro-cyclical monetary policy if we keep it up too long.

VICE CHAIRMAN SOLOMON. But I shudder to think of what would have happened to the economy if we had followed M1 on its crazy turns in the last year.

MR. BALLE. Well, I would never have proposed that we follow it in the last year, Tony, because we did realize in a timely way that something funny was going on in velocity and were wise enough to offset it. It would have been a disaster if we had not let M1 increase by 8-1/2 percent in 1982 instead of the targeted 2-1/2 to 5-1/2 percent in view of what in fact was going on in its velocity and the big drop that we had first in inflation and then in interest rates. We are convinced, and I think a lot of people around the table would be too, that what happened was that the opportunity cost of holding money dropped very significantly with that drop in interest rates and, therefore, more money was demanded. It wasn't that the

demand curve was shifting but that the amount of money demanded moving along a given curve was going up, given the fact that interest rates were coming down.

MS. TEETERS. John, I think there was one cost of our monetarist experiment that tends to be overlooked, which was the extraordinary economic cost of the volatility of the rates. The volatility of short-term rates is not all that serious, but when it was transmitted totally and completely into long-term rates it helped to destroy the long-term market. I think not only the level of the rates but the volatility of the rates was just economically unacceptable. And if we do consider going back to M1, I think we ought to keep in mind that it has a very high cost in other areas.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I've been troubled by the great deal of stability that we've had in the funds rate, which does seem to harken back to olden times. But the error that was committed in olden times was not that we became too tight as a result of holding the interest rate but that we became too easy. The natural tendency in an expansion, it seems to me, is to generate that kind of pressure. Inflation expectations rise and, therefore, the real rate falls, and at a given [nominal] interest rate we have really less restraint than before. Then the aggregates have tended to expand too rapidly. We have not had that this time, if we discount the earlier behavior of M1. But I think one can't discount it completely; at least one has to give it a chance to unwind now, as Steve said. If too much of it went into the economy earlier, there's a good reason why it should move more slowly right now. I think the whole picture of the economy that we're seeing is one of much greater strength than we expected. Half a year ago we talked about the fragile expansion. Now, each time we meet the expansion is a little stronger and the forecast is raised a little more. We're not borrowing from the future and cutting down the amount of expansion we see hereafter; but we're more or less maintaining the projection for the future, which means that the economy is moving at a higher level and, therefore, a potentially more inflationary level. The tendency to approach the capacity ceilings early is part of that general picture. So, if I had to make a move right now, I would certainly want to make it in an upward direction. But I think we don't really have to make a move. There are a lot of factors on both sides and enough leeway continues to exist so that we can wait; I don't know whether we should enjoy but, at any rate, we can wait.

CHAIRMAN VOLCKER. Mr. Wallace.

MR. WALLACE. Mr. Chairman, if I may be permitted a somewhat different view: I come out very supportive of the position that Governor Wallich just expressed, although I think that perhaps some move is called for. It is becoming increasingly clear that the recovery is more robust than we expected earlier, and I think that combined with the prospects of continued high deficits will put upward pressure on interest rates, notwithstanding Secretary Regan's position. I think we will see increased inflationary pressures. As Governor Partee has observed, inventory building is going to continue; the inventory/sales ratio is low; corporate retained earnings are ceasing to be a factor holding rates down. So, I'm inclined to

believe that the best thing that we can do now is to let the funds rate move up closer to the 10 percent level and send a signal to the market that we continue to be concerned about future inflation. Therefore, I would come out in favor of a "B-" position or "B" perhaps with a higher borrowing assumption that would carry a clear indication that we would like to see the funds rate move higher. I might add parenthetically that my preference would be to see the record stated in terms of that rate. But knowing that that's not an option we have, I would opt for "B" or "B-."

CHAIRMAN VOLCKER. Mr. Roberts.

MR. ROBERTS. Well, I share John Balles' concern about the persistent deceleration in the rate of M1 [growth] as evidenced from August through October. I don't think any major change is called for. Alternative B, which would show [M1 growth] rates of 6 percent in November and 9 percent in December would be fine with me. I would be cautious in view of the character of the expansion about moving over to "A," because if we were successful in achieving it, John, that would have us moving into the new year at an 11 percent rate of growth in M1, which I think would be excessive. I agree that there has been some unwinding, but all of our research would indicate that if we persist in restraint of this magnitude, we will in fact stop the recovery sometime beyond midyear of next year. So, I would like to see us get back on track and address the issue in terms of the monetary base and M1 and let the interest rate fall out wherever it does.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I'm very much in John Balles' camp. Or, to put it in a slightly different way, he has returned to a camp that I never left. We've heard a lot of criticism of M1 during recent years and a lot of it I think has been warranted, but nobody has put forward anything that seems to have any promise, from my viewpoint, of being a better intermediate target. Just to cite one case: The only thing that would have led anybody to predict the amount of strength we've had in the recovery was growth of M1. So, I still focus most of my attention on M1, but I'm very pragmatic about it. If Steve's probing into the behavior of M1A or anything else turns up something that will behave better, then I'll gladly switch. Given that position, on the basis of past experience I think there's a legitimate reason to be concerned about this deceleration that we've had in M1 and to conclude that it conceivably might have a negative impact on business next year if it continues. So, I can understand why John has some sympathy for easing up a bit to stimulate the rate of growth in the money supply. I would have a lot of sympathy for that point, particularly if I thought that if it turns around the other way we would move as quickly to snug up. But there are a couple of reasons, or maybe three reasons even, why I don't think that would be very wise right now. One, of course, is that the economy does seem to be very strong. I will buy pretty much Lyle's and others' argument on that. And after the kind of growth we've had in the money supply, again narrowly defined, I think it's probably inevitable that we will have a few bumps and grinds as we try to get this back down to where it ought to be.

SPEAKER(?). Bumps and grinds?

MR. BLACK. That was a Freudian slip! But in more technical terms, we've been playing around inadvertently with the seasonal adjustment factors. I think it's at least conceivable or plausible that the introduction of the MMDAs and also the advent of the OCDs and the inadvertent seasonal adjustment that seems to have gotten into our monetary policy the last several years may have biased our seasonal adjustment factors upward for these last three months, in which case the reported figures are going to be lower than they really ought to be. If that analysis is right, then that's a reason for not being quite as concerned about the weakness we see there. So, to get to the bottom line, which I probably should have gone to directly, I would go for alternative B.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Mr. Chairman, I would favor what I would call a small precautionary move in the direction of firming a little at this point. What I would have in mind is perhaps letting the borrowing level go up to \$750 million or so, or maybe a bit higher, with the funds rate moving from 9-1/4 to 9-1/2 percent to 9-1/2 to 9-3/4 percent, at least for the time being. I say that, of course, primarily because of the way that I'm looking at the economy. Again, if I look at the staff forecast for 1984 fourth-quarter-over-fourth-quarter, nominal GNP growth is 9 percent--4.3 percent real and 4.9 percent inflation. If indeed the risks are on the up side, as I think they are at the moment, it seems to me quite plausible that we may be looking at a situation in 1984 where we will have to try to restrain somewhat the growth of prices and nominal GNP. Now, when I look at the specifications that Steve has put together, even though one has to take the numbers with a grain of salt, alternative B growth rates for M1, M2, and M3 basically between October and December range from 7-1/2 to 8-1/2 percent, which are still pretty robust numbers. I don't think I would care too much if growth came out in that range, but I sure wouldn't want it to come out much higher than that. Those considerations, in combination with my view of the economy, lead me to believe that a small move in the direction of a little precautionary restraint right now might prove to be very helpful in the longer run.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I share Governor Wallich's concerns that we're looking at an economy that is growing a lot faster than we thought it was going to. And I think it's probably still going to show a lot of robustness over the next couple of quarters. If I think about the kind of posture monetary policy for the course of 1984 that's likely to be consistent with keeping the economy's growth rate down to 4-1/2 percent or so and inflation no worse than 4-1/2 to 5 percent, I end up concluding that we're going to need higher interest rates. I just don't see how we can run a monetary policy that provides the kind of expansion in the money supply that is in the staff's forecast for 1984 together with this horrendously stimulative fiscal policy in an economy that has a tremendous amount of cyclical momentum developing and not have an outcome that's rather different from what the staff is suggesting. I've listened to what [Governor Martin] has said with great interest. I think there are considerations on the down side that we need to think about. But in my judgment the risks of an overrun are much greater at this point. So, I agree with Jerry fully. I think a precautionary step in the direction of firming is necessary

and desirable. It wouldn't have to be done today. It can even wait until the December meeting. But the sooner we make it, I think the better off we're going to be. Jerry's specs were a "B-;" I had put down \$700 to \$800 for borrowing and 9-1/2 to 9-3/4 percent [for fed funds] and that's exactly where he was. So, I agree fully with him.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, I have a good deal of sympathy with the comments that John Balles made about M1. I think the time is fast approaching when we need to take a hard look at restoring M1 to some degree of respectability, which apparently was lost along the way. But I part company with John at that point. Even if we look at M1, the situation of the economy is such that I don't believe any degree of loosening would be appropriate at this time. I would associate myself with the remarks just made by Governor Gramley. I think that the concern we have is with a very robust economy in 1984. The projections, even of the money supply, are on the high side. So, the bottom line for me is "B-." I too had a borrowing range of about \$750 million with a fed funds rate of 9-3/4 percent. So, I would come out for a B- alternative, although alternative B would certainly be acceptable. But I wouldn't like to see the Committee move below "B" to a position closer to "A."

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I'd like to enter a vote for alternative B. One reason is my concern with regard to our leadership in the world economy and our impact as the world's biggest market for the less developed countries. Speaking on a domestic basis, though, we are not yet back to a trend line in real GNP, described using the last decade or 1973 to 1980 or whatever you feel is the appropriate period. Things have changed so much, though, in the last few years--financial institutions, financial instruments, business institutions and the way they're dealing with their unions, and the world competition that has now been vectored into this country. But I think any fine-tuning, considering how little we know about our institutions and their financial instruments and how they perform today, would go just as fine-tuning has always gone--not so fine. So, a slight firming of interest rates or so-called precautionary firming, given the disappearance of Reg Q and given the removal of other estoppels that the government had built into the financial system, means that if we're going to tighten it has to be, in my not so humble opinion, a major tightening--not a firming of a 1/4 or 3/8 of a point. And I'm not prepared to support either a fine-tuning or a major move. I understand most of us are not willing to support a major move. I'd like to see the status quo and borrowing between \$600 and \$700 million, with emphasis on the lower number.

CHAIRMAN VOLCKER. Mr. Solomon.

VICE CHAIRMAN SOLOMON. On balance, I also come out for staying as we are, although I do think it's quite possible that next month we will have to give more consideration to a tightening move. In addition to the arguments that have been offered around the table against a move at this point, I would add that a tightening move at this point really would not be understood in the markets. It would be totally unexpected in the country at large. And I think there would

be a lot of speculation that the Fed is expecting much more inflation next year, notwithstanding the Chairman's testimony in which he said it could be 4-1/4 percent or less. I think the only way the country would understand a tightening move at this point would be [to conclude] that we privately are expecting significantly higher inflation. Obviously, I'm not saying that that should be the sole governing consideration, but it does seem to me that, even though one can make an argument for a precautionary move, the force of the justification for that might be very much clearer at our next meeting. So, I would vote to stay where we are and for borrowing in the \$650 million area.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Well, I have some sympathy for those around the table who have spoken for returning to M1, but not now. I also have some sympathy for those who expressed the position that we will indeed face a period in the future when some additional tightening is needed, but I think not now. I would come out very much as Tony has for retaining our current position with a borrowing level of about \$650 million. This may be the month to sit back and enjoy it. Come next month, before Christmas, I believe we may be the grinch who takes away Christmas. It may be appropriate to make a modest move, even in view of the international situation, in the upcoming month or two.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, I would end up associating myself with those who are in favor of continuing the current policy, probably alternative B. I think we are in a period in which things are going well, and that suggests that change would not be appropriate. It's clear that the economy is far better now than we expected earlier and it is continuing to improve. If this continues into the time of the next meeting, we may want to move modestly toward tightening. But I think there still are enough uncertainties that I'd like to see a few more cards before taking that move. Therefore, I favor alternative B with a borrowing level at about its current target level.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, even though I believe in an activist monetary policy, I think there are times when the best thing to do is to do nothing. It seems to me that the case that Lyle made is one which has a reasonably high probability of being right. I think we have an environment for a strong surge in capital spending next year but the case is not that clear that we ought to be moving right now. One thing that I think we learned from the May 24 decision of the Committee is that with the new mortgage market we really have a very powerful instrument in monetary policy in that the mortgage rate now is so responsive to changes in monetary policy. We used to think of a six-month lag between a change in policy and the impact in real activity. What we found when we pushed up interest rates in June is that we got a decline in new home sales in July, a decline in permits in August, and a decline in starts in September. The textbook would suggest that we should not expect that prompt a response. I think the reason we got it is that we now have a mortgage market in which the thrift institutions are mortgage bankers; they take in mortgage

packages and sell them in the market. And they have to get a market rate on them if they're going to sell them. So, that means that a fairly modest change in monetary policy can have a pretty big impact on the housing sector pretty fast.

VICE CHAIRMAN SOLOMON. How do you explain the fact that in the last month or the last few weeks--I don't know exactly what time period--while there has been a firming in bond yields there has been a slight lowering in mortgage rates?

MR. MORRIS. Well, there certainly hasn't been much of a firming in bond yields and the short-term money rate structure has been moving down.

MR. MARTIN. Tony, the variable rate mortgage is coming into its own; it's 30 to 45 percent of the market. I mean no disrespect, but we don't have good measures of those rates and how those loans are traded in the markets. If we had that data, I don't think you'd find the discrepancy. You're talking about fixed-rate mortgages.

MR. GUFFEY. There has also been quite an inflow into the S&Ls recently.

VICE CHAIRMAN SOLOMON. Yes. The explanation I heard is that the competition among the thrifts has become more intense for mortgage business and they are--

MR. PARTEE. That could be true and Frank's point could still be right. But I think it is true that we have a very responsive mortgage rate.

VICE CHAIRMAN SOLOMON. I wasn't disagreeing with that.

MR. MORRIS. I think this is the tool we can use when we get evidence that the capital goods boom is really taking off. I don't think the evidence is strong enough yet, so I would argue for alternative B.

CHAIRMAN VOLCKER. Does anybody else have a comment?

MR. RICE. I'd just like to register a position on this. Because of the way I see the economy developing, I have a good deal of sympathy for the position taken by Lyle and Jerry. That is, I can see the case for some precautionary firming at the present time. But I'm not prepared actually to move in that direction at this time. I do agree that we have to be looking in a firming direction and I agree with Tony that it may be next time [we meet]. But I think Tony put his finger on the problem and that is that if we took any firming action at all at the present time, it simply wouldn't be understood. The public and markets are looking at the aggregates and they see them either well within the ranges or toward the bottom of the ranges. And if we firm up now, even in a slight way, it simply wouldn't be easily understood. But at the same time, we still ought to keep ourselves looking in that direction. And if we expect that we may have to take some firming action next time, perhaps we ought to find some language in the directive this time to prepare the markets for such an action.

CHAIRMAN VOLCKER. Mr. Balles.



MR. BALLEES. Mr. Chairman, perhaps I should defer; my question has nothing to do with current specifications. I would like to ask Steve a question about our meeting yesterday after you get through this. Pardon me.

CHAIRMAN VOLCKER. We have a couple of people for whom I do not have an opinion indicated, if they want to express an opinion.

MS. TEETERS. I thought I did at the beginning. I'm very much for just staying where we are and not moving one way or the other. But I'm a little curious: What do you expect to know in a month that we don't know now? We will have one more unemployment rate and we will have the flash on the fourth-quarter GNP, which is not a very good number.

MR. PARTEE. We won't have Christmas sales yet.

MS. TEETERS. And we won't have Christmas sales. So, I'm not sure that we're going to have that much more information in another month. Now, if we go into February, we'll have a firmer number on the GNP and another two or three months of unemployment data and hopefully good information on the international side. Those seem to me the things necessary for making a decision.

MR. GRAMLEY. I agree with what you say. You're right that we are not going to have any better numbers a month from now. The problem is that if we wait until February the capital spending plans for 1984 would be set in concrete; they are all being developed now. The Christmas sales boom will have taken place and there is all the inventory planning that stems from that. And it then becomes late. If I'm right in my hypothesis, and I may not be, we're going to find ourselves in February wishing we had acted last August.

VICE CHAIRMAN SOLOMON. Even though I agree that we won't have any better monthly numbers, there would be some anecdotal information. We may have a better feeling for how the fourth quarter will be coming in and what is happening in business fixed investment.

MR. BOEHNE. Ideas grow on people over time; they sink in.

MR. RICE. The most important thing is that there will be time for a few more public statements to the effect that we might be firming.

CHAIRMAN VOLCKER. Have you expressed a view, Governor Partee?

MR. PARTEE. Yes, I'm for staying right where we are.

CHAIRMAN VOLCKER. I thought I had that correctly.

MR. PARTEE. I thought I rebutted John.

MR. BALLEES. It would have been a very peaceful meeting except for me; I'm sorry about that.

CHAIRMAN VOLCKER. Well, I have a lot of people who want to stay more or less where we are, with some tendency toward tightening by some. I don't recall many times when we've tightened prematurely.

MR. PARTEE. I do.

MR. MARTIN. Let's keep it up.

MR. RICE. Yes.

MR. MORRIS. January of 1981.

SPEAKER(?). January, 1982.

MR. MORRIS. January, 1982.

MR. PARTEE. How about May of 1975?

MS. TEETERS. How about May of 1983?

MR. RICE. May, 1983.

MR. PARTEE. We tightened because the aggregates went up.

MR. RICE. To no avail.

CHAIRMAN VOLCKER. We tightened in January '81, if I remember.

MR. MORRIS. We pushed short-term interest rates up 400 basis points in response to a rise in M1.

CHAIRMAN VOLCKER. Well, we'll have to discuss next time or the time after how we get into a disinflationary policy if we want to have a disinflationary policy over a period of time. A five percent M1 figure, if M1 is going to return to normal, looks a bit high to me.

MR. GRAMLEY. Five percent M1?

CHAIRMAN VOLCKER. I'm talking about next year.

MR. GRAMLEY. That isn't what the staff is projecting for next year.

CHAIRMAN VOLCKER. I don't care what the staff is predicting; it looks a bit high.

MR. GRAMLEY. Yes, but if 5 percent looks high, what does 7 percent look like?

MR. PARTEE. Very high!

CHAIRMAN VOLCKER. If it returns to normal--I don't know if it's going to; that's a big if. Well, I could convince myself to tighten up a little now, although I don't feel that strongly about it. But I'm not sure we will want to wait for the next meeting if the aggregates turn out on the high side and the business news remains that good. We can start off where we are and stay there if everything

goes according to the forecast. If the aggregates or the economy come in more strongly, obviously, we have room in these directives to move anyway. I think we ought to discuss how to bias this a bit, if we want to. I don't know that it takes any change in the wording. What does the [current] directive say? Maybe we should start out by saying "maintain the existing [degree of reserve restraint]." And if we believe what the staff tells us, that 8-1/2 percent [for growth in M2 and M3] can remain, I think. We're in a mid-quarter meeting; I don't see any necessity [to change] the second sentence. The third sentence may be a question. Let me just look at it.

MR. WALLICH. We could say "further evidence of strength in the economy."

CHAIRMAN VOLCKER. I could reverse the sentence in a sense, and say "Depending on evidence about the strength of economic recovery and other factors bearing on the business and inflation outlook, greater restraint would be acceptable in the context of more rapid expansion in the aggregates."

MR. GRAMLEY. That sounds good to me.

MR. PARTEE. And then pick up the--

CHAIRMAN VOLCKER. Reverse [the order].

MR. PARTEE. Yes, because we might well have continued slow growth in the aggregates. That [bounceback] is something that has been projected; we don't see it.

MR. BLACK. If you think of this seasonal adjustment thing--

MS. TEETERS. We can reverse it.

CHAIRMAN VOLCKER. Well, reversing it is an obvious possibility.

VICE CHAIRMAN SOLOMON. But isn't there an implication if we say that greater restraint would be acceptable should the aggregates expand more rapidly, that that's the only condition under which we would go to greater restraint? And yet, of course, we could have weakness in the aggregates and still have enough business evidence that we would want to move a little. What I'm saying is that we ought to put a little more emphasis on the strength of the economic recovery considerations in that sentence.

CHAIRMAN VOLCKER. I think we have discovered historically that we can't take care of every permutation and combination in these sentences, but--

MR. RICE. Well, we do mention the strength of the economy.

MR. MORRIS. The beginning clause "Depending on the evidence about the strength of economic recovery and"--

VICE CHAIRMAN SOLOMON. Yes, I understand that. I just felt [we needed] a little more emphasis there rather than on the aggregates.

MR. BOEHNE. Well, instead of "would" we could say "might." It seems to me that that's a slightly weaker word.

VICE CHAIRMAN SOLOMON. I don't think that would be--

MR. GRAMLEY. If we leave it the way the Chairman has expressed it and we understand that he's thinking of taking into account particularly the business news as well as the aggregates, that seems to me to be reasonable. We can't express all the different--

CHAIRMAN VOLCKER. If we do it this way, the first half of the sentence seems to be simple enough. If you want to put in a balancing thing on the other side-- But it's weighed somewhat differently, I guess. "Depending on evidence about the strength of economic recovery and other factors bearing on the business and inflation outlook, somewhat greater restraint would be acceptable should the aggregates expand more rapidly."

VICE CHAIRMAN SOLOMON. You could achieve what I want simply by putting in one adjective: "Depending on evidence about the increasing strength of economic recovery."

MR. PARTEE. But the rate of increase is decreasing.

MR. RICE. Well, it's a question of whether it really is increasing. The rate of expansion [may be] decelerating at some point and if you get that and continue to do so--

MR. PARTEE. We just received the production number today and that is a half point less than last month.

VICE CHAIRMAN SOLOMON. Okay. What I'm trying here may be quite technical--

MS. TEETERS. How about "continued"?

MR. RICE. Yes, "continued" would do it.

VICE CHAIRMAN SOLOMON. Right, or "continuing." If we do that, it gives a flavor of the Committee's concern that there may be something further down the road.

MR. MARTIN. Some of the Committee's concern.

MR. PARTEE. Yes, that's acceptable to me.

VICE CHAIRMAN SOLOMON. And then make the change you suggested, Paul.

CHAIRMAN VOLCKER. What change that I suggested?

MS. TEETERS. Reversing the clauses.

VICE CHAIRMAN SOLOMON. Reversing.

MR. PARTEE. The market might notice that.

CHAIRMAN VOLCKER. I don't quite see how to word this second thought. We could just put in a semicolon and say "lesser restraint would be acceptable in the context of a significant shortfall in the growth of the aggregates from current expectations." I'm not sure we're saying that; I don't know what significant is if business looked even stronger and the aggregates had a shortfall. That's the main problem. Then what would we do?

MS. TEETERS. Call a meeting.

MR. BALLE. Have a telephone call.

CHAIRMAN VOLCKER. Well, we could do it that way. We could just put a semicolon and say "lesser restraint would be acceptable..."

VICE CHAIRMAN SOLOMON. How about "might be acceptable"?

CHAIRMAN VOLCKER. Well, that's all right.

CHAIRMAN VOLCKER. Now, what number do you want to put in there?

MS. TEETERS. Shouldn't we put 7-1/2 percent?

CHAIRMAN VOLCKER. We had 7 percent before?

MR. BERNARD. Yes.

CHAIRMAN VOLCKER. I think if we leave 7 percent, we have to put 7 percent or less.

MS. TEETERS. "Or somewhat more." It's 7-1/2 percent.

MR. PARTEE. It's 5-1/2 percent.

MR. MORRIS. But we could change it to read October through December. Then we could put 7 percent.

CHAIRMAN VOLCKER. Well, we could do that but it's fine-tuning. I think we can either put in 5 to 6 percent percent or 7 percent or less. Or we can change it to October through December and leave it at 7 percent.

MR. PARTEE. I think I prefer September to December, Paul. We [generally] follow this policy and I'd keep it. And I think 5 to 6 percent sounds like a quite respectful growth rate.

CHAIRMAN VOLCKER. Put 5 to 6 percent?

MR. CORRIGAN. For September-to-December 5 to 6 percent gets you almost up to the top of alternative A.

MR. PARTEE. Or almost down to "C."

MR. MARTIN. Somewhere between "A" and "C."

MR. PARTEE. It's just an indicator. We're not even running on this.

CHAIRMAN VOLCKER. I don't mind putting in "7 percent or less," as a matter of fact. I'd just put in the "or less" to take account of the fact that we've had some [slowing]. But 5 to 6 percent is all right with me.

MR. PARTEE. 5 to 6 percent or less.

CHAIRMAN VOLCKER. 7 percent or less.

MR. GRAMLEY. That "7 percent or less" sounds so blooming high that it leaves the whole thing wide open.

MR. ROBERTS. Well, isn't "7 percent or less" saying that we're staying on the track that we were on but weren't accomplishing? Isn't that all it's saying? And that implies a higher growth rate from now until year-end, which is in line with "B."

MR. CORRIGAN. For September-to-December 7 percent growth for M1 is higher than 9 percent--

MR. ROBERTS. He said "7 percent or less," I thought.

MR. PARTEE. Zero is a lot less than "C."

MR. MARTIN. We could say "zero or more"!

MR. ROBERTS. I don't think we ought to imply that 5-1/2 percent is the desired path from here forward.

CHAIRMAN VOLCKER. Do you think it's too low or too high?

MR. ROBERTS. I think it's too low.

VICE CHAIRMAN SOLOMON. We did rebase. You were critical to rebasing, I presume, so haven't we--

MR. ROBERTS. Monthly rates aren't affected by rebasing.

VICE CHAIRMAN SOLOMON. No. But I don't see the reasons for pushing hard to get above the bottom of the rebased range.

MR. ROBERTS. I'm not thinking about the base or the range. I'm thinking about a very restrictive 3-month pattern that is likely to extend into at least another month, and I would like to see a pattern of expansion in the money supply from here forward so that we're getting back more on the track that we set out to be on when we said we wanted a 7 percent rate of growth.

MR. PARTEE. Well, 5 to 6 percent, Ted would give you what you would require--quite a lot of expansion.

MR. ROBERTS. Yes, I understand. I could go either way: with 7 percent or less or 5 to 6 percent. I just said I don't see anything wrong with 7 percent or less.

CHAIRMAN VOLCKER. Well, I can certainly go either way. I don't think it's a terribly sensitive decision given our ability to--

MS. TEETERS. I think 5 to 6 percent gives a little more information to the market.

MR. PARTEE. I'm worried about the open-end nature of the "or less." If we say "or somewhat less," that perhaps is sending it too high, so I prefer 5 to 6 percent.

CHAIRMAN VOLCKER. Do we want 5 to 6 percent?

MR. MARTIN. Yes, 5 to 6 percent.

MR. ROBERTS. That should imply tightening, while in actuality we're loosening if we accomplish this. A 5 to 6 percent growth gives you 7-1/2 percent October to December, and we've been saying 7 percent from another period. Now if we say 5 to 6 percent, it sounds like less but it's really more.

CHAIRMAN VOLCKER. Do you want to put in a phrase at the beginning of the sentence such as "Given the relatively slow growth in October, the Committee anticipated..."?

SPEAKER(?). That would do it.

CHAIRMAN VOLCKER. Well, are we putting the 6 to 10 percent [funds rate range] down at the bottom?

MR. PARTEE. Are we looking at the long-term aggregates or the credit numbers?

CHAIRMAN VOLCKER. We don't put credit numbers in here.

MR. PARTEE. It's in there somewhere--that they are within the [long-term] range or something.

MR. AXILROD. It's right after that part of the sentence.

CHAIRMAN VOLCKER. Well, the figures aren't right up-to-date but we have had a quite rapid increase in the liquidity figure through the period for which we last had figures and the debt figure was within the range but not low.

MS. TEETERS. They include Treasury borrowing.

CHAIRMAN VOLCKER. They include the Treasury bills. Those have been going up, commercial paper has been going up, and bankers acceptances have been going up. Over the summer liquidity was rising at an annual rate of around 8 to 12 percent. Anyhow, I guess this is where we are. If nobody has any comments, we can vote.

MR. BLACK. Mr. Chairman, do we have 8-1/2 percent for M2 and M3 growth?

CHAIRMAN VOLCKER. Yes, 8-1/2 percent for M2 and M3. I think that's what "B" shows.

MR. ROBERTS. Before we vote, Mr. Chairman, what does this imply about borrowing?

CHAIRMAN VOLCKER. \$650 million.

MR. ROBERTS. May I ask a question of the staff? Steve, is the \$650 million intended to be consistent with your November and December [projections of] 6 and 9 percent growth in M1?

MR. AXILROD. That's what we are projecting but with regard to 2-month projections for M1, as the Committee knows, the results can be highly variable.

MR. ROBERTS. You don't see anything in the level of borrowing you've been assuming that is associated with these constrictive growth rates up to now?

MR. AXILROD. Well, we assume that the market conditions associated with this level of borrowing--I'm not sure I'm answering your question--would result in roughly a 7-1/2 percent growth in M1. Now, the market conditions can be a little variable with this level of borrowing, depending on other things, and the demand for money can be a little variable. But that is our best estimate at this time.

MR. ROBERTS. That's what I wanted to know.

CHAIRMAN VOLCKER. It's the best estimate, which might be called a big fat guess.

MR. AXILROD. No, it's a careful study of various models with judgment applied!

MR. PARTEE. Plus or minus 300!

CHAIRMAN VOLCKER. What they are saying is that, with this rate of business activity, they think it's going to pull up M1 even at the current levels of interest rates and borrowings. But that is a judgment about this unwinding being over or possibly over. But who knows?

MR. AXILROD. And I might add, Mr. Chairman, just in the context of what was said before about business activity being strong, that it's not clear to me from the recent performance that that necessarily means stronger M1. It could be that people are just writing checks on their NOW accounts, which is sort of stored up savings, and we could get lower M1 with strengthening business activity.

CHAIRMAN VOLCKER. Well, I haven't looked at the figures in the last couple of weeks, but I think one can argue that the money market deposit accounts, which are not in M1, remain very low, don't they?

MR. AXILROD. They are edging up, but essentially--

CHAIRMAN VOLCKER. Well, maybe it's beginning to go up again. But it looks suspiciously like there was this great attraction into that account when it was first offered. There was a lot of publicity and very high interest rates. People put more money in there than they wanted to hold in there permanently, and as things settle down they are taking advantage of other slightly higher rates in 6-month



certificates or 3-month certificates or something else. And we may get some of the same phenomenon perhaps on NOW accounts.

MR. AXILROD. It really isn't worth making a federal case, but with respect to the alleged pickup in activity in September and October, if that occurred, the component of M1 that showed the strength was currency, where growth picked up to 10 percent. It's probably a coincidence, but right in that same period the NOW account growth virtually stopped.

CHAIRMAN VOLCKER. Well, the thing that has looked best over the past year or the past two years is not M1 but old M1A. What has that been doing recently?

MR. AXILROD. I'll get the figure here in a minute. That grew very little. In September and October it picked up to around a 2 percent annual rate of growth, which is slow, and it declined slightly in August.

CHAIRMAN VOLCKER. So, you have an increase in currency offset by a decrease in demand deposits?

MR. AXILROD. That's right.

MR. WALLICH. Wasn't there a reason for that--namely that the interest-bearing checkable deposits went up? So, you can't look at M1A in isolation anymore.

VICE CHAIRMAN SOLOMON. Except old M1 was just as weak, apparently, in that time period.

CHAIRMAN VOLCKER. Well, during this very recent period apparently. But last year when M1 was going up so rapidly and velocity was declining, old M1A was not going up so rapidly and the velocity looked more normal. That may have been a pure coincidence, but I--

MR. AXILROD. Well, we've had for three months this sort of unwinding of the build-up in demand deposits, which we were somewhat at a loss to explain. We really expected that to start coming down earlier in the summer. We've had that in August, September, and October. And now we're anticipating that that will stop and will start going back up.

CHAIRMAN VOLCKER. Well, what we have is: "maintain the existing degree of reserve restraint." We have 8-1/2 percent in those blanks and then "Depending on evidence about the continued strength of economic recovery and other factors bearing on the business and inflation outlook, somewhat greater restraint would be acceptable should the aggregates expand more rapidly; lesser restraint might be acceptable in the context of a significant shortfall in the growth of the aggregates from current expectations. Given the relatively slow growth in October, the Committee anticipates that M1 growth at an annual rate of around 5 to 6 percent from September to December will be consistent with its fourth-quarter objectives for the broader aggregates..." All the rest would remain the same with 6 to 10 percent [for the funds rate range].

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Yes
Governor Gramley	Yes
President Guffey	Yes
President Keehn	Yes
Governor Martin	Yes
President Morris	Yes
Governor Partee	Yes
Governor Rice	Yes
President Roberts	Yes
Governor Teeters	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. I guess we are finished aren't we, Mr. Secretary?

END OF MEETING